

Pension ANALYST

Important Information

Plan Design

April 2008



IRS Publishes Proposed Regulations for Hybrid Plans

WHO'S AFFECTED These developments affect sponsors of and participants in hybrid plans, such as cash balance plans and pension equity plans. These developments also affect plan sponsors that are considering converting traditional defined benefit plans to a hybrid plan design.

BACKGROUND AND SUMMARY Hybrid plans, such as cash balance plans and pension equity plans, have become popular retirement plan designs. A hybrid plan is a retirement plan that combines the characteristics of a defined contribution plan and a defined benefit plan.

The enactment of the [Pension Protection Act of 2006](#) (PPA) into law on August 17, 2006, clarified the legal status of cash balance plans and other hybrid plan designs created after June 29, 2005, under ERISA, the Internal Revenue Code and the Age Discrimination in Employment Act (ADEA), if they satisfy certain requirements. Last year, the [IRS issued Notice 2007-6](#) which contained transitional guidance regarding hybrid plan designs and administration under PPA, until the IRS issued additional guidance.

Recently, the IRS issued proposed regulations on hybrid plan designs to reflect the changes required by PPA. The proposed rules incorporate the transitional guidance provided under Notice 2007-6. The proposed rules also offer guidance on a variety of issues regarding:

- Vesting;
- Age discrimination;
- Conversions;
- Market rate of return; and
- Plan amendments.

The proposed rules do not provide any guidance with respect to backloading issues. However, interim backloading guidance and retroactive relief has been provided in [Revenue Ruling 2008-7](#).

ACTION AND NEXT STEPS Sponsors of cash balance and pension equity plans should carefully read the information contained in this *Pension Analyst*. We encourage plan sponsors to discuss the contents of this publication with their legal counsel and their plan's enrolled actuary to determine how this most recent guidance impacts their plans.

The proposed rules are effective for plan years beginning on or after January 1, 2009. Since the regulations are only proposed, plan sponsors are not required to comply with them. However, plan sponsors that do comply with these regulations before 2009 in the design and administration of their hybrid plans are assured

that the IRS will consider their plans to be in compliance with the new rules. Any more restrictive rules contained in the final regulations will apply on a prospective basis.

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Hybrid plans, such as cash balance plans and pension equity plans (PEPs), are a special type of defined benefit pension plan that combine features of a defined benefit plan and a defined contribution plan. Today's most common hybrid plan designs are defined benefit plans that express benefits as the value of a hypothetical account balance. Participants receive statements that display the accumulation of contributions and interest credited to their hypothetical accounts.

The enactment of PPA imposed new vesting and interest crediting requirements on hybrid plans. The new law also eliminated "whipsaw," which can result in a difference between the lump sum value a participant can receive in a distribution and the stated value of the employee's hypothetical account balance. PPA also eliminated the issue of "wear-away" with respect to conversions occurring after June 29, 2005.

To assist plan sponsors in the administration of their hybrid plans and satisfy the requirements of PPA, the IRS has now issued proposed rules.

Proposed Regulations

Definitions

The proposed rules permit a [statutory hybrid plan](#) to determine the present value of benefits under a lump-sum based formula as the:

- Amount of the hypothetical account maintained for the participant; or
- Current value of the accumulated percentage of the participant's final average compensation under that formula.

For this purpose, the rules introduce the following new definitions to take into account those situations where a plan provides more than one benefit formula:

- **Statutory hybrid plan** means a defined benefit plan that contains a [statutory hybrid benefit formula](#).
- **Statutory hybrid benefit formula** means a benefit formula that is either a lump-sum based benefit formula or a formula that has an effect similar to a lump-sum based benefit formula

because it is reasonably expected to result in a larger annual benefit at normal retirement age for an older participant than for a similarly situated, younger individual.

- **Lump sum-based benefit formula** means a benefit formula used to determine any part of a participant's accumulated benefit, which provides a benefit that is expressed as the balance of a hypothetical account (in a cash balance plan) or as the current value of the accumulated percentage of the participant's final average compensation (in a PEP).
- **Accumulated benefit** means the participant's benefit, as expressed under the terms of the plan accrued to that date. It does not include any benefits the participant is entitled to receive in the future, but which have not yet been credited (e.g., interest credits to be earned in the future on an existing cash balance account).

Vesting

In general, PPA imposes a faster minimum vesting requirement on hybrid plans, beginning with the 2008 plan year. These rules provide that if any portion of a participant's accrued benefit is determined under a statutory hybrid benefit formula, the participant must be 100% vested in his accrued benefit after no more than three years of service. This requirement applies on a participant-by-participant basis and applies to the participant's entire benefit, not just the portion of the participant's benefit that is determined under a statutory hybrid benefit formula.

In addition, if a participant's accrued benefit is the larger of two (or more) benefit amounts, and at least one of those formulas is a statutory hybrid benefit formula, the participant's accrued benefit is subject to the three-year vesting requirement, even if the benefit under the statutory hybrid benefit formula is ultimately smaller than under the other formula.

For plans in existence on June 29, 2005, this vesting requirement is first effective for plan years beginning on or after January 1, 2008. A [delayed effective date](#) applies to existing [collectively bargained plans](#). For all other plans, this vesting requirement applies as of the plan's effective date.

Age Discrimination Safe Harbor

A defined benefit plan cannot stop or reduce the rate of a participant's benefit accruals based solely on the participant's age. Under the proposed rules, a hybrid plan is treated as satisfying this requirement if, as determined as of any date, a participant's accumulated benefit is not less than any similarly situated, younger participant's accumulated benefit.

This safe harbor standard is available only where a participant's accumulated benefit under the terms of the plan is expressed as:

- An annuity payable at normal retirement age (or current age, if later); or
- The balance of a hypothetical account (in a cash balance plan); or
- The current value of the accumulated percentage of the employee's final average compensation (in a PEP).

An individual is "similarly situated" to another individual if the two individuals are identical in every respect, other than age, that is relevant in determining a participant's benefit under the plan, including (but not limited to): period of service, compensation, position, date of hire, and work history. Any characteristic that is relevant for determining benefits under the plan that is based directly or indirectly on age must be disregarded.

Conversion Protection

To ensure that benefits and early retirement subsidies do not “wear-away” as a result of a conversion from a traditional defined benefit plan to a hybrid plan, the proposed rules generally require any plan conversion occurring after June 29, 2005, to provide a benefit that is at least equal to the sum of the benefits:

- Accrued through the date of conversion; and
- Earned after the conversion date.

However, the proposed rules also provide an alternative approach, which requires the plan to establish an opening hypothetical account balance as part of the conversion and keep separate track of the:

- Opening hypothetical account balance (which is the lump sum actuarial equivalent of the accrued benefit) and related interest credits; and
- Post-conversion hypothetical contributions and related interest credits.

Under this alternative method, the plan must provide that, when a participant begins to receive benefit payments, the plan will determine whether the benefit attributable to the opening hypothetical account payable in a particular form of benefit is greater than or equal to the benefit accrued under the plan prior to the date of conversion that is payable in the same form of benefit. The greater of these two amounts must be combined with the benefit attributable to post-conversion credits to determine the amount of benefit actually payable.

Market Rate of Return

To satisfy the benefit accrual requirements, a statutory hybrid plan must use an interest crediting rate that does not exceed the market rate of return. An “interest crediting rate” is the rate applied under the terms of the plan to increase a participant’s benefit to the extent the benefit increase is not the result of a participant’s additional service for the employer.

An interest crediting rate will not exceed a market rate of return if it is equal to or less than any of the following rates:

- The safe harbor rates described in Notice 96-8;
- The interest rates on 30-year Treasury securities; and
- The interest rate on long-term investment grade corporate bonds prior to PPA for plan years beginning before 2008 and the third-segment bond rate, determined without regard to the transitional rules, used for minimum funding purposes for subsequent plan years.

The interest crediting rate must be determined daily or in accordance with a specified lookback month and stability period described in IRS regulations. In addition, the proposed rules require plans to specify the frequency at which interest credits are made in the plan. Interest credits must be made at least annually.

The regulations also require statutory hybrid plans to provide that interest credits will not result in a hypothetical account balance as of a participant’s annuity starting date being less than the sum of the hypothetical contributions. In other words, the minimum interest crediting rate over a participant’s entire participation period in a plan is zero. It is possible for an interest crediting rate in a given year to be negative, though there would be an expectation that the variable rate would rarely be negative for an extended period of time. A “hypothetical contribution” is any amount credited under a statutory hybrid plan other than an interest credit.

The IRS has indicated that it intends to issue further guidance on a number of issues related to market rate of return. However, until this additional guidance is released, plan sponsors are urged to be cautious in adopting interest crediting rates other than those permitted in these proposed regulations.

Plan Amendments and [Anti-Cutback Relief](#)

In general, plans cannot be amended to reduce or eliminate benefits that have already accrued. This is referred to as the “anti-cutback rule.” However, plan sponsors may delay adopting plan amendments that incorporate PPA provisions until the last day of the first plan year beginning on or after January 1, 2009 (January 1, 2011, in the case of governmental plans). In general, required plan amendments may be effective retroactively and will not violate the anti-cutback rule, as long as the plan is operated in compliance with the new provisions as of the appropriate effective dates and the amendments are adopted by the required deadline.

In addition, these proposed rules permit sponsors of hybrid plans to make the following amendments without worrying about the anti-cutback rule:

- A plan that provides for a single sum payment to a participant that exceeds the participant’s hypothetical account balance or accumulated percentage of final average compensation may be amended to eliminate the excess payment amount for payments made after August 17, 2006. However, if such an amendment is adopted retroactively, then a notice of benefit accrual reductions ([“204\(h\) notice”](#)) must be provided at least 30 days before the earliest date on which the plan is operated in accordance with the amendment.
- A plan may be amended to change the interest crediting rate from one of the rates specified in Notice 96-8 to another Notice 96-8 rate, as long as the new rate is not further from the maximum margin than the old rate.

Pension Equity Plans

Under a PEP design, benefits are described as a percentage of final average compensation. The percentage is determined on the basis of points received for each year of service. PEPs also provide interest credits for the period between a participant’s termination of employment and the payment of benefits.

The proposed rules do not include any guidance specifically relating to PEPs, other than the ability to define a participant’s accrued benefit as the accumulated percentage of final average compensation (as discussed above). The IRS had previously requested comments on this plan design and is continuing to evaluate these comments.

Effective Dates

The proposed rules are effective for plan years beginning on or after January 1, 2009. Since the regulations are only proposed, plan sponsors are not required to comply with them. However, plan sponsors that do comply with these regulations before 2009 in the design and administration of their hybrid plans are assured that the IRS will consider their plans to be in compliance with the new rules. Any more restrictive rules contained in the final regulations will apply on a prospective basis.

A delayed effective date applies to plans maintained pursuant to collective bargaining agreements ratified on or before August 17, 2006. For these plans, the proposed regulations are effective for plan years beginning on or after the earlier of:

- The later of the date on which the last of those collective bargaining agreements terminates (without extensions), or January 1, 2008; or
- January 1, 2010.

For purposes of these rules, a plan is considered to be a collectively bargained plan if at least 25% of the participants in the plan are members of collective bargaining units for which benefit levels under the plan are specified under a collective bargaining agreement.

Next Steps

The IRS has requested public comments on these regulations. The comment deadline is March 27, 2008, and Prudential Retirement is participating with various industry groups to provide comments.

Plan sponsors should read the contents of this publication to evaluate the impact on existing hybrid plans and determine if plan design or administrative changes may be required. Sponsors of traditional plans that have been considering conversion to a hybrid design should carefully review the additional conversion guidance provided in these regulations. Sponsors may want to discuss this guidance with their legal counsel and their plan's enrolled actuary. The plan's enrolled actuary is in the best position to provide assistance regarding these proposed rules.

Pension Analyst by Prudential Retirement

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