Pension Analyst
Important information Plan design February 2011

IRS issues final and 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. They also affect plan sponsors that are considering converting a traditional defined benefit plan to a hybrid plan design.

Background and summary

Hybrid plans, such as cash balance and pension equity plans, are common plan designs. A hybrid plan is a retirement plan that combines features 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 and other hybrid plan designs created after June 29, 2005, if they satisfy certain requirements. To assist plan sponsors in designing and administering these plans, the IRS issued Notice 2007-6 and proposed regulations in 2007.

Recently, the IRS issued final hybrid plan regulations to reflect the changes made by PPA. The final regulations incorporate the transitional guidance provided under Notice 2007-6 and generally adopt the provisions of the proposed rules. They offer guidance on a variety of issues regarding:

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

At the same time, the IRS issued additional proposed regulations. These rules provide guidance on certain issues that are not addressed in the final regulations such as:

- Interest crediting rates;
- Changes in interest crediting basis; and
- Additional conversion guidance.

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. In some situations, plan amendments may be needed.

The final regulations generally apply to plan years beginning on or after January 1, 2011. The proposed regulations apply to plan years beginning on or after January 1, 2012, but may be relied upon until then.

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Highlights of final and proposed rules for hybrid plans

Hybrid plans, such as cash balance plans and pension equity plans (PEPs), are a special type of defined benefit pension plan that combines features of a defined benefit plan and a defined contribution plan. Most hybrid plans express benefits as the value of a hypothetical account balance. Participants receive statements that reflect the accumulation of contributions and interest credited to their hypothetical accounts. The IRS has recently issued final regulations that confirm and expand the 2007 proposed regulations regarding the treatment of hybrid plans.

Final regulations

Definitions

Like the proposed regulations, the final rules permit a statutory hybrid plan to determine the present value of benefits under a lump sum-based benefit formula as the current balance of:

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

The final regulations retain the following definitions to take into account 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.
- ***Lump sum-based benefit formula*** means a benefit formula used to determine any part of a participant's accumulated benefit that provides a benefit as the current balance of a hypothetical account or as the current value of an accumulated percentage of the participant's final average compensation.
- ***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).

The final regulations clarify that the benefit attributable to after-tax employee contributions, rollover contributions and other similar employee contributions is disregarded when determining whether a benefit formula is a lump sum-based benefit formula. Variable annuity contracts with guaranteed interest rates of at least 5% and post-retirement adjustments (e.g., cost-of-living increases) are also disregarded.

Vesting

As required by PPA, the final regulations reflect a faster minimum vesting requirement for hybrid plans. 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 vesting requirement applies on a participant-by-participant basis and applies to the participant's entire benefit, not just the portion of the benefit that is determined under a statutory hybrid benefit formula. If a participant's accrued benefit is the greater of two (or more) benefit amounts, where each amount is determined under a different benefit formula and at least one of those formulas is a statutory hybrid benefit formula, the participant's entire accrued benefit is subject to the three-year vesting requirement.

For plans in existence on June 29, 2005, the vesting requirement is first effective for plan years beginning on or after January 1, 2008. As clarified by WRERA, the new vesting rules apply to participants who have an hour of service after December 31, 2007. 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.

Safe harbor for age discrimination

A defined benefit plan cannot stop or reduce the rate of a participant's benefit accruals based solely on the participant's age. The final regulations confirm that a hybrid plan satisfies this requirement, if when 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 is expressed as:

- An annuity payable at normal retirement age (or current age, if later); or
- The current 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 (except age) 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 factor. Any characteristic that is relevant for determining benefits under the plan that is based directly or indirectly on age must be disregarded.

To satisfy the safe harbor, the individuals' benefits must be compared using the same form of benefit. For example, one individual's annuity benefit cannot be compared to another individual's hypothetical account balance. The safe harbor cannot be satisfied if the plan contains a suspension of benefits provision that reduces or eliminates interest credits for participants who work beyond normal retirement age.

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 final rules require that any plan conversion occurring after June 29, 2005, provide a benefit that is at least equal to the sum (A + B approach) of the benefits:

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

An alternative approach requires the plan to establish an opening hypothetical account balance (the lump sum of the accrued benefit) as part of the conversion and keep separate track of the:

- Opening hypothetical account balance and related interest credits; and
- Post-conversion hypothetical contributions and related interest credits.

Under this alternative method, when a participant begins to receive benefit payments, the plan must 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.

An employer is treated as having adopted a conversion amendment if the employer adopts an amendment that coordinates benefits under a plan that is not a statutory hybrid plan with benefits under a separate statutory hybrid plan. If an employee's employer changes as a result of a merger, acquisition or other corporate transaction, the two employers are treated as a single employer for purposes of applying this rule.

Multiple amendments that result in a conversion are considered to be a conversion amendment, even if the amendments would not be conversion amendments individually. If an amendment to provide a benefit under a statutory hybrid benefit formula is adopted within three years after adoption of an amendment to reduce non-statutory hybrid benefit formula benefits, then those amendments must be aggregated to determine whether a conversion amendment has been adopted. If such an amendment is adopted more than three years later, the amendments would not be aggregated unless the facts and circumstances indicate that they should be aggregated.

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 or imputed service for the employer.

The final regulations provide the following list of rates that are deemed not to exceed the market rate of return:

- The safe harbor rates described in Notice 96-8;
- The interest rates on 30-year Treasury securities;
- The first, second and third segment bond rates used for purposes of determining lump sum payments or for calculating minimum funding (determined with or without regard to transitional rules); and
- The rate of increase with respect to eligible cost-of-living index described in the minimum required distribution rules, increased by 300 basis points.

A plan that credits interest must specify how those credits are determined and how and when they are credited. A plan must determine the interest crediting rate that will apply for each plan year using either:

- The applicable periodic interest rate that applies over the current period; or
- The rate used in accordance with a specified lookback month and stability period. The stability period and lookback period do not have to be the same as those used to determine lump sum payments under the plan.

Plans must specify the frequency at which interest credits are made. Interest credits must be made at least annually. If interest is credited more frequently than annually (for example, daily, monthly or quarterly) then the interest rate credit for that period cannot exceed the pro-rata portion of the annual interest credit. The interest rate may be compounded more frequently than annually.

The regulations note that, in the case of a governmental plan, a rate of return or method of crediting interest that complies with any provision of applicable federal, state or local law will be treated as both a market rate of return and a permissible method of crediting interest.

Revisions to the interest crediting rate

The final regulations clarify that the right to future interest credits that are not conditioned on future service are a protected benefit. Therefore, an amendment to revise the interest crediting rate on accrued benefits is a prohibited cutback if under any circumstances, the revised rate results in a lower interest credit rate as of any date after the amendment.

However, the regulations do provide one exception to the anti-cutback rules. A plan may be amended to change the interest crediting rate for future interest credits from one of the Notice 96-8 rates (or from the first or second segment rate) to the rate of interest on long-term investment grade bonds, provided the amendment effective date is at least 30 days after the adoption of the amendment and the new interest rate is not lower than the interest credit rate that would have applied before the amendment.

Proposed regulations

The proposed regulations address a variety of issues that were not addressed in the final regulations.

Market rate of return

The proposed regulations expand the list of approved interest crediting rates to include the following:

- A fixed rate of interest that does not exceed 5%;
- An actual rate of return on plan assets, provided that plan assets are diversified to minimize the volatility of returns;
- A rate of return on certain regulated investment companies (RICs) that is reasonably expected not to be significantly more volatile than the broad United States equities market. For example, a RIC that has most of its assets invested in securities of issues concentrated in an industry sector or a country other than the United States would not meet this requirement.
- Greater of rates. In limited circumstances, a plan can provide interest credits based on the greater of two or more interest crediting rates.

Under these rules, a plan is not required to provide interest credits on amounts distributed before the end of the plan's interest crediting period.

In addition, a plan may credit interest after a participant reaches normal retirement age at a rate that satisfies any required actuarial increase.

Changes in interest crediting rates

The proposed regulations create a special rule that applies when a plan is amended to change the interest crediting rate. If an amendment changes the plan's interest crediting rate from one approved rate to another approved rate, it must provide that any participant's benefit will never be less than what it would have been had the old rate remained in effect.

The IRS plans to issue future guidance that will provide relief from anti-cutback rules to allow reductions in interest crediting rates to the extent necessary to comply with the market rate of return requirements.

Additional conversion guidance

The proposed regulations provide an additional conversion option that eliminates the need to compare benefits at a participant's annuity starting date. This alternative is available if the following conditions are satisfied:

- The participant elects to receive a single-sum payment equal to the sum of the pre-conversion and post-conversion benefit;
- The benefit payable after conversion is not less than the protected benefit with respect to pre-conversion service;
- The opening account balance is determined by Code section 417(e);
- The index used to provide future interest credits is at least as great as the interest rate used to establish the opening account balance for each participant; and
- The plan provides a death benefit equal to the account balance at date of death.

Plans must still separately recordkeep the pre-conversion benefit to satisfy the conversion protection requirements. In order to satisfy the anti-cutback rules, the participant's benefit after the effective date of the conversion must not be less than the participant's protected benefit with respect to service before the effective date of the conversion.

Additional benefit calculation guidance

The proposed rules permit a statutory hybrid plan to calculate optional forms of benefit based on the actuarial equivalent of the participant's current balance of the hypothetical account using reasonable actuarial assumptions. However, the regulations do not define "reasonable actuarial assumptions."

Effective dates

The final regulations are generally effective for plan years beginning on and after January 1, 2011. However, the approved interest crediting rates apply to plan years beginning on or after January 1, 2012. For plan years that begin before January 1, 2012, plans may use a rate that is permitted under the final regulations or the 2010 proposed regulations.

The proposed regulations apply to plan years beginning on or after January 1, 2012. However, plans may follow the provisions of the proposed regulations, the 2010 final regulations, the 2007 proposed regulations, and Notice 2007-6.

For collectively-bargained plans, the vesting and interest crediting rules do not apply to plan years beginning before the earlier of:

- The later of the termination of the collective bargaining agreement or January 1, 2008; or
- January 1, 2010.

If a plan covers both collectively-bargained and non-collectively-bargained employees, it will be considered a collectively bargained plan if:

- At least 25% of the *participants in* the plan are members of collective bargaining units for which the benefit levels under the plan are specified under a collective bargaining agreement; or
- At least 50% of the *employees benefiting under* the plan are members of collective bargaining units for which the benefit levels under the plan are specified under a collective bargaining agreement.

Next steps

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 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 final and proposed rules.

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