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Pension ANALYST

Important Information | Plan Design | February 2007

IRS Provides Guidance 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 sponsors of qualified defined benefit pension plans that are considering converting their traditional defined benefit plan to a hybrid plan design.

BACKGROUND AND SUMMARY In 1999, the IRS suspended the processing of determination letter applications involving defined benefit plans that converted to a hybrid plan design until final regulations addressing age discrimination issues were issued or clarifying legislation was enacted. With no action on either front, the IRS has accumulated a backlog of approximately 1,200 cases subject to this moratorium.

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.

As a result, the IRS recently issued Notice 2007-6 announcing that they are beginning to process determination letters and examination cases for hybrid plans. The IRS intends to resolve a significant majority of the backlog by the end of 2007.

This Notice also contains transitional guidance regarding hybrid plan design and administration under PPA, until the IRS issues additional guidance. The IRS intends to issue significant additional guidance on hybrid plans in 2007.

Finally, the IRS is also requesting comments on certain issues relating to hybrid plans. The IRS must receive these comments by April 16, 2007.

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 THIS ISSUE

Background
Determination Letters
Transitional Guidance
Definition of Statutory Hybrid Plan

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Prudential Financial

Interest Credits
Anti-Cutback Relief
Vesting
Conversion Amendments
Safe Harbor for Conversions Related to Mergers and Acquisitions
Plan Termination Requirements
Comments and Future Regulations
Next Steps

Background

Hybrid plans, such as cash balance plans and pension equity plans (PEP) 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. While hybrid plans offer annuity payments and provide that the normal form of payment is an annuity, a lump sum payment option is almost always available at termination of employment. However, these plans have been controversial with opponents claiming that hybrid plans violate benefit accrual rules, fail to protect accrued benefits in conversions and discriminate against older workers.

PPA now provides guidance to enable hybrid plans to satisfy the ERISA, Internal Revenue Code and ADEA rules prohibiting age discrimination. PPA imposes new vesting and interest crediting requirements on hybrid plans. The new law also includes guidance on the payment of lump sums to eliminate "whipsaw," which can result in a difference between the lump sum value and the stated value of the employee's hypothetical account balance. Finally, PPA provides guidance concerning prospective conversions after June 29, 2005, which eliminates the issue of "wear-away" in some hybrid plans.

To help plan sponsors administer their hybrid plans and satisfy the requirements of PPA until formal regulations are issued, the IRS recently issued Notice 2007-6.

Determination Letters

In 1999, the IRS suspended the processing of determination letter applications for traditional defined benefit plan conversions to a hybrid plan design. The IRS had taken this action, pending study on issues raised in such conversions, including the impact of these conversions on older employees. Due to the enactment of PPA, the IRS has now resumed the processing of determination letters for plans that were subject to the 1999 suspension ("moratorium plans"). However, the IRS will impose certain guidelines when processing these moratorium plans for determination letters:

- A moratorium plan may still satisfy the benefit accrual rules even if it provides for the frontloading of interest credits (i.e., the participant receives the right to future interest credits regardless of whether the participant continues employment);
- Determination letters issued to moratorium plans converted prior to June 30, 2005, will not consider and may not be relied on as to whether the plan satisfies the new requirements of PPA, including the effect of any wearaway;
- Determination letters issued to moratorium plans that converted to hybrid plans after June 29, 2005, must satisfy the PPA conversion requirements; and

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- Until further guidance is issued, the IRS will not process a moratorium plan that does not satisfy the requirements of Notice 96-8 with respect to distributions made before August 18, 2006. Notice 96-8 required cash balance plans to calculate single sum distributions by projecting the balance of the participant's hypothetical account to normal retirement age, converting the amount to an annuity, and then discounting it back to the payment date to determine the present value of the lump sum.

The Pension Benefit Guaranty Corporation (PBGC) has also informed the IRS that a terminating plan with a termination date prior to August 18, 2006, cannot apply the PPA plan termination requirements in determining benefit liabilities with respect to distributions made by the terminating plan.

In a special edition of its Employee Plans News newsletter, the IRS recently explained how the processing of prior determination letter requests for moratorium plans would coordinate with EGTRRA determination letter requests for "Cycle A" and "Cycle B" filers. In fact, the IRS will process the EGTRRA request and any previously filed determination letter applications that have been subject to the moratorium together. These plans will receive priority treatment. As a result, hybrid plan sponsors that fall within Cycle B may want to file during the first few months of that cycle, which begins on February 1, 2007, to receive a faster response on their new determination letter requests.

Transitional Guidance

Definition of Statutory Hybrid Plan

The transitional guidance applies to statutory hybrid plans and the conversion of a defined benefit plan into a statutory hybrid plan. The IRS defines a statutory hybrid plan as a plan that:

- Is a "lump sum based plan;" or
- Has a similar effect to a lump sum based plan.

A "lump sum based plan" is a defined benefit plan that expresses a participant's accumulated benefit (i.e., the participant's benefit accrued to date) 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). The definition also includes plans that calculate the participant's accrued benefit as the actuarial equivalent of the hypothetical account balance or accumulated percentage. Whether a plan is a lump sum based plan depends on how the participant's accumulated benefit is expressed under the terms of the plan, and not on whether the plan provides for an optional lump sum form of payment.

A plan "has a similar effect to a lump sum based plan" if it expresses a participant's accrued benefit (payable at normal retirement age) as a benefit that includes automatic periodic increases through normal retirement age that results in the payment of a larger amount at normal retirement age to a similarly situated younger participant.

Interest Credits

PPA requires that any interest credit to a participant's hypothetical account be not less than zero and not more than the market rate of return. The IRS expects to issue guidance in 2007 that addresses the market rate of return rules, including preservation of capital and minimum rate of return rules.

However, until that guidance is issued, the IRS has provided the following safe harbor market rates of return:

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- The rate of interest on long-term investment grade corporate bonds (for plan years prior to January 1, 2008);
- Third segment rate of the new yield curve for subsequent plan years;
- The 30-year Treasury security rate; or
- The sum of any of the standard indices and the associated margin for that index described in IRS Notice 96-8.

Anti-Cutback Relief

The transitional guidance provides relief for a plan that pays lump sum benefits that exceeded the participant's hypothetical account balance or accumulated percentage of final average compensation. A plan may be amended to eliminate the excess for distributions paid after August 17, 2006. These amendments must be made on or before the last day of the plan year beginning on or after January 1, 2009 (2011 for governmental plans).

However, if the plan is amended, a 204(h) notice must be provided at least 30 days before the effective date of the amendment. If an amendment significantly reduces the rate of future benefit accruals and is adopted retroactively (i.e., after the effective date of the amendment) the 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.

Vesting

The Notice confirms that a participant in a statutory hybrid plan must be 100% vested upon completion of three years of service. This new vesting requirement is generally effective on and after June 29, 2005. However, plans that were in existence on June 29, 2005, do not have to comply with the new rule until the first day of the 2008 plan year.

Conversion Amendments

PPA requires a defined benefit plan that is converted into a hybrid plan after June 29, 2005, to protect the accrued benefit of any participant who was a participant immediately before the date the conversion amendment was adopted. PPA eliminates the issue of "wear-away" in some hybrid plan designs in which a participant has a significant pre-conversion accrued benefit and does not accrue an additional benefit under the hybrid plan until the accrued benefit earned under the old defined benefit formula "wears away."

The transitional guidance confirms that a participant's accrued benefit after the conversion amendment cannot be less than the sum of:

- The participant's accrued benefit for years of service before the effective date of the conversion amendment, determined under the terms of the old plan; and
- The participant's accrued benefit for years of service after the effective date of the amendment, determined under the new plan's terms.

The guidance also requires a plan to credit a participant's account with the amount of any early retirement benefit or retirement-type subsidy for the plan year in which the participant retires, provided the participant satisfies the requirements to receive the subsidy or benefits, such as years of service and age requirements. The date on which a participant retires means the annuity starting date for the participant's benefit. This transitional guidance applies to a conversion amendment that is adopted and effective after June 29, 2005.

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Safe Harbor for Conversions Related to Mergers and Acquisitions

The IRS expects to issue regulations no later than August 17, 2007, regarding amendments that convert a traditional defined benefit plan into a statutory hybrid plan for a group of individuals who become employees as the result of a merger, acquisition, or similar corporate transaction.

Until regulatory guidance is issued, the IRS has indicated that a plan amendment will satisfy the requirements of PPA if each participant's benefit under the plan is not less than the sum of the participant's protected benefit with respect to service:

- Before the effective date of the conversion amendment; and
- On and after the effective date of the conversion amendment.

The benefits determined before and after the conversion amendment must each be determined in the same manner as if they were provided under separate plans that are independent of each other (e.g., without any benefit offsets).

Plan Termination Requirements

This Notice confirms that a plan that uses a variable rate for interest crediting purposes, must use an interest rate for determining accrued benefits at plan termination that is equal to the average of the interest rates used under the plan during the five-year period ending on the termination date. The interest rate and mortality table used for determining benefits in the form of an annuity payable at normal retirement age is the rate and table specified under the plan as of the termination date.

Comments and Future Regulations

The IRS expects to issue regulations in 2007 regarding statutory hybrid plans. In developing this additional guidance, the IRS has requested comments on related issues, such as the:

- Definition of market rate of return;
- Application of the transitional guidance to pension equity plans; and
- Application of any special rules when only a portion of a participant's accrued benefit is determined by reference to a hypothetical account.

Next Steps

The IRS has now provided plan sponsors with interim guidance for hybrid plan designs. Sponsors should read the contents of this publication to evaluate the impact of the guidance on their hybrid plans and determine if plan design or plan administration changes may be required. Sponsors may want to discuss this guidance with their plan's enrolled actuary. The plan's enrolled actuary is in the best position to provide assistance regarding the transition rules.

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Editor: Mitzi Romano (860) 534-2768

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