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Pension ANALYST

Important Information Plan Design September 2006

Pension Protection Act of 2006 And Other Recent Developments Provide Guidance on Hybrid Plans

This is the first of a series of *Pension Analyst* publications providing information on specific aspects of the 2006 pension reform legislation affecting defined benefit plans. Of course, the 1000 pages of this new law are only the starting point for changes affecting plan design and administration. In the upcoming weeks, months, and years, regulatory agencies will publish guidance to add substance to the general directives provided by the law. To make this information more meaningful to plan sponsors, we are presenting it in discrete pieces, beginning with this discussion of the law's hybrid plan provisions.

<u>WHO'S AFFECTED</u> 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 traditional defined benefit plans to a hybrid plan design.

<u>BACKGROUND AND SUMMARY</u> Hybrid 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 pension plan. Today's most common hybrid designs are defined benefit plans that express benefits as the value of a hypothetical account. 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. Of course, this lump sum payment may be rolled over to another retirement plan or individual retirement account. The common perception is that hybrid plans are easier for participants to understand and appreciate.

However, this plan design has been controversial with opponents claiming that hybrid plans violate benefit accrual rules, fail to protect accrued benefits in conversions and discriminate against older workers. As a result, these plan designs have been challenged in the courts.

Recently, there have been two developments that provide guidance with respect to hybrid plans. First, on August 7, the Seventh Circuit Court of Appeals reversed the decision of the lower court and ruled in *Cooper v. IBM Personal Pension Plan* that IBM's cash balance plan formula is not age discriminatory.

Then, on August 17, President Bush signed the Pension Protection Act of 2006 (PPA) into law. PPA clarifies the legal status of cash balance and other hybrid plan designs created after June 29, 2005, under

ERISA, the Internal Revenue Code and the Age Discrimination in Employment Act, if they satisfy certain conditions. PPA also protects a participant's accrued benefit earned prior to the date of conversion.

This *Pension Analyst* will discuss the key provisions of the PPA that affect hybrid plans as well as the recent IBM court decision.

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 these developments impact their plans.

IN THIS ISSUE

Hybrid Plan Provisions of the Pension Protection Act of 2006

Hybrid plans, such as cash balance plans and pension equity plans, are a special type of defined benefit pension plan that combine features of a defined benefit pension plan and a defined contribution plan. Under a cash balance plan, benefit calculations are based on a participant's hypothetical account. Annual allocations are made to this hypothetical account based on a percentage of the participant's compensation for the year, known as "pay credits" and earnings on the account, known as "interest credits." When a participant receives a pay credit for a year of service, he also receives the right to receive future interest on that pay credit, regardless of whether he continues employment, as long as the account remains in the plan. As a result, if an employee terminates employment and defers distribution to a later date, interest credits will continue to be credited to that employee's hypothetical account.

Under a pension equity plan (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 distribution of benefits.

Age Discrimination Rules

Under these hybrid plan designs, younger employees have a longer period of time to earn interest credits on a pay credit. Therefore, a pay credit received at a younger age may provide a larger benefit at normal retirement age than the same pay credit received at an older age. As a result, opponents of hybrid plans have suggested that they discriminate against older workers. Lawsuits regarding this issue have resulted in split decisions.

PPA now provides guidance that will enable hybrid plans to satisfy the ERISA, Internal Revenue Code (Code) and Age Discrimination in Employment Act (ADEA) rules prohibiting age discrimination. To satisfy these rules, a participant's accrued benefit must be equal to or greater than that of any similarly situated younger individual -- i.e., an individual who is identical in every respect, including period of service, compensation, position, date of hire, work history, but not age -- who is or could be a participant in the plan.

In evaluating a participant's accrued benefit, the subsidized portion of any earlier retirement benefit or any retirement-type subsidy is not considered.

PPA provides that the accrued benefit can be calculated as:

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

Rules for "Applicable Defined Benefit Plans"

The new law requires that an "applicable defined benefit plan" must comply with the age discrimination rules. PPA defines an "applicable defined benefit plan" as a defined benefit plan under which any portion of an accrued benefit is calculated as the balance of a hypothetical account maintained under a cash balance plan or as an accumulated percentage of the participant's final average compensation under a PEP.

These plans must satisfy the following requirements:

- ***Vesting***. The plan must provide that each employee who has completed at least three years of service is 100% vested in that portion of his accrued benefit attributable to both past and future employer contributions. There is no alternative graded vesting schedule.

- ***Interest Credits***. The plan must provide that any interest credit is not less than zero and is not greater than the market rate of return. A plan may provide for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to or the greater of a fixed or variable rate of return. However, an interest credit of less than zero cannot result in the account balance being less than the amount of contributions credited to the account. The new law directs the IRS to issue rules regarding the calculation of the market rate of return and permissible methods of crediting interest to the accounts.

  If the interest rate is a variable rate and the plan terminates, the rate used to determine accrued benefits under the plan must be equal to the average of the interest rates used under the plan during the past five-year period ending on the termination date.

- ***Lump Sum Payments***. Defined benefit plans, including hybrid plans, normally pay benefits in the form of an annuity. Plans may also offer optional forms of payment, such as a lump sum. If a benefit is paid under an optional form, the payments must be actuarially equivalent to the present value of a life annuity payable at normal retirement age. Many hybrid plans permit a lump sum payment of a participant's hypothetical account at termination of employment. In the past, problems have occurred when the plan uses one interest rate for purposes of the interest credit that is used to project the account balance forward to normal retirement age and a different interest rate to discount the benefit back to the payment date to determine present lump sum value. This can result in a difference between the lump sum value and the stated value of the employee's hypothetical account balance, which is known as "whipsaw." If the plan's interest credit rate is higher than the required discount interest rate, the lump sum will be greater than the participant's hypothetical account balance.

PPA eliminates whipsaw and provides that the valuation rules are satisfied if the present value of the participant's accrued benefit equals the balance of the hypothetical account (based on interest rates not greater than a market rate of return) or an accumulated percentage of the participant's final average compensation. This provision applies to payments made after August 17, 2006.

- ***Prospective Conversions.*** 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. The participant's total accrued benefit *cannot be less than* the participant's accrued benefit for years of service before the effective date of the amendment *plus* the participant's accrued benefit for years of service after the effective date of the amendment. As a result, this 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."

  Under the new rules, any early retirement subsidy accrued before the date of the conversion under the traditional defined benefit plan formula is preserved. However, the participant must still satisfy the requirements to receive the early retirement subsidy, such as years of service and age requirements. A hybrid plan is not required to pay out an early retirement subsidy in a lump sum payment.

- ***Plan Termination.*** If the plan uses a variable rate for interest crediting purposes, then upon plan termination, the rate of interest used to determine accrued benefits must be 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.

- ***Effective Dates.*** For hybrid plans in existence on June 29, 2005, the interest rate and vesting requirements apply to plan years beginning after December 31, 2007. However, a plan sponsor may elect to have these requirements apply for any period beginning after June 29, 2005, and before the first plan year beginning after December 31, 2007. A delayed effective date applies to plans maintained pursuant to collective bargaining agreements.

  The plan conversion rules apply to plan amendments that are adopted and effective after June 29, 2005. However, a plan sponsor may elect to have these rules apply to plan amendments adopted before June 29, 2005, but effective after that date.

Prior Conversions

PPA sanctions prospective conversions of traditional defined benefit plans to a hybrid plan design. However, it does not address or clarify the legal status of conversions made before June 29, 2005. As a result, the legality of prior conversions may continue to be debated in the courts.

Mergers and Acquisitions

It is unclear how plan sponsors should apply the hybrid plan rules in the event of a corporate transaction, such as a merger or acquisition. As a result, PPA requires the IRS to publish regulations no later than 12 months after the date of enactment to provide guidance with respect to this issue.

Cooper v. IBM Personal Pension Plan

On August 7, 2006, the Court of Appeals for the Seventh Circuit reversed the district court's controversial decision in *Cooper v. IBM Personal Pension Plan* and ruled that the plan's hybrid plan design did not violate ADEA rules and did not discriminate against older workers.

Background

In 1999, IBM converted its traditional defined benefit pension plan to a cash balance plan. The conversion applied to participants who had not reached age 50 or did not have five years of service. Other participants remained covered under the traditional defined benefit formula. Under the cash balance plan formula, IBM provided an annual 5% pay credit to each participant and interest credits set at 100 basis points above the rate on one-year Treasury bills. A group of participants challenged the conversion, alleging that younger employees receive interest credits over a longer period of time, and as the result of compounded interest, accrue a larger benefit.

District Court Decision

The district court agreed with the participants and ruled that the cash balance plan discriminated against older workers since they had a shorter period of time than younger workers to accrue benefits, which resulted in a smaller accrued benefit. This conclusion conflicted with several prior district court decisions.

Court of Appeals Decision

On appeal, the Court of Appeals for the Seventh Circuit Court reversed the lower court's decision and found that IBM's plan design did not violate ERISA's nondiscrimination rules. The court held that benefit accruals should be measured by looking at the employer's contributions which were age-neutral and not the value of the contributions after earnings. The Court of Appeals also concluded that the term "benefit accrual" refers to the allocation of contributions or credits and that as long as the plan's allocation of credits or contributions to participants' accounts is age-neutral, it is not discriminatory. The court noted that the effects of compounded interest on allocations are age-neutral and disagreed with the district court that the time value of money is age discriminatory. The court reasoned that if interest is not treated as age discriminatory for a defined contribution plan, it should not be treated as discriminatory for a defined benefit plan.

Recently, the Court of Appeals refused the participants' request to rehear the case. It is uncertain as to whether the participants will appeal the decision to the Supreme Court and whether the Supreme Court will decide to review this case.

Although the Court of Appeal's decision provides an interesting analysis of the age discrimination issue, it only applies to a limited jurisdiction. It remains to be seen how other courts will deal with this issue in light of the *IBM* decision.

Next Steps

PPA now provides plan sponsors with general rules for hybrid plan designs. Sponsors should read the contents of this publication to evaluate the impact of these rules on their hybrid plans and determine if plan design changes may be required. For example, the interest rate credited to participants' hypothetical accounts may need to be examined once the IRS issues guidance. In addition, the plan may need to accelerate vesting by the first plan year beginning after December 31, 2007, unless an earlier date is otherwise elected.

Sponsors of traditional defined benefit plans may want to discuss the hybrid plan provisions of the PPA with their legal counsel and their plan's enrolled actuary to determine whether a conversion to a hybrid plan design is appropriate. Prudential Retirement's enrolled actuaries have years of experience in hybrid plan designs. They can provide creative solutions in helping plan sponsors achieve their plan design goals as well as build a secure retirement for their participants. They are well prepared to respond to any conversion questions as well as discuss any other provisions of the Pension Protection Act.

Pension Analyst by Prudential Retirement
The Pension Analyst is published by Prudential Retirement, a Prudential Financial business, to provide clients with information on current legislation and regulatory developments affecting qualified retirement plans.

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