Cash Balance Plan Regulations Address Many Knotty Issues

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The Internal Revenue Service and Treasury Department recently issued much anticipated final and proposed regulations relating to cash balance and other hybrid plans (75 Fed. Reg. 64,123, 10/19/10, the “final regulations”) and (75 Fed. Reg. 64,197, 10/19/10, the “proposed regulations”). The regulations interpret many of the new rules for cash balance and other hybrid plans that were enacted in the Pension Protection Act of 2006 (Pub. L. No. 109-280). The final regulations generally incorporate the transitional guidance provided under Notice 2007-6 and generally follow the 2007 proposed regulations. The October 2010 proposed regulations focus on a number of issues that were left unaddressed in the 2007 proposed regulations.

Together, the regulations interpret the primary changes made by PPA related to:
- general age discrimination rules,
- market-rate-of-return limits for interest credits,
- anti-wear-away protections for plan conversions,
- three-year vesting, and
- elimination of whipsaw and other distribution valuation rules.

General Age Discrimination Rules. The final regulations implement PPA’s age discrimination safe harbor for hybrid plans by permitting a plan to be deemed compliant with the general age discrimination rules for pension plan benefit formulas if each benefit formula under the plan can never result in a younger participant receiving greater benefits than a similarly situated older participant.

Market-Rate-of-Return Limits for Interest Credits. Under PPA, a hybrid plan is deemed to be noncompliant with age discrimination rules if interest credits under the plan are based on a rate that exceeds a market rate of...
return. The final regulations interpret the basic interest credit requirements by identifying various bond-based indices that a plan may select to use as a market rate.

The proposed regulations would permit an equity-based market rate of return by allowing the use of a rate of return on plan assets or a rate of return on certain mutual funds. The proposed regulations also would permit the use of a fixed rate of up to 5 percent, an annual fixed-rate floor of up to 4 percent if combined with a permissible bond-based variable rate, and a cumulative fixed-rate floor of up to 3 percent if combined with a permissible equity-based rate.

**Anti-Wear-Away Protections for Plan Conversions.** The final regulations implement the anti-wear away provisions for plans that convert to a hybrid formula after June 29, 2005, by requiring that plan benefits be no less than the sum of the pre-conversion benefit plus the post-conversion hybrid benefit formula.

The proposed regulations would add a conversion option under which an opening hybrid benefit amount could be determined without having to provide “A plus B” benefit protection.

**Three-Year Vesting.** For plans in place before June 29, 2005, the final regulations implement a three-year vesting requirement that applies to participants with an hour of service on or after Jan. 1, 2008, for which any part of the participant’s benefit is determined under a hybrid plan benefit formula.

**Elimination of Whipsaw and Other Distribution Valuation Rules.** The final regulations generally permit a hybrid plan to provide lump-sum benefits equal to the current value of a participant’s lump sum-based benefit under the plan.

The proposed regulations would permit hybrid plans to value annuity forms of distribution by applying reasonable actuarial assumptions to the current lump-sum benefit.

**Effective Dates**

The final regulations generally are effective for plan years beginning on and after Jan. 1, 2011. However, the list of permissible market-rate-of-return indices are effective for plan years beginning on and after Jan. 1, 2012.

The proposed regulations would generally become effective for plan years beginning on or after Jan. 1, 2012.

Plan sponsors may rely on the final regulations, the 2007 proposed regulations, the new proposed regulations, and Notice 2007-6 for the periods between the statutory effective date, which generally is June 29, 2005, and the effective date of the regulations.

IRS indicated that it expects to provide cutback relief for plans that must be amended to change an existing interest crediting rate to a rate that is not in excess of the final market-rate-of-return limits. There currently is no express cutback relief for such a change.

**Plan Amendments**

These regulations generally did not extend the amendment deadline for making any plan amendments that may be necessary to comply with the new hybrid plan rules. However, in Notice 2010-77 issued Nov. 30, 2010, IRS generally extended the amendment deadline for most hybrid plan rules until the end of the 2011 plan year.

The deadline for plan amendments that may be necessary to comply with PPA’s statutory changes for hybrid plans generally was set to expire at the end of the first plan year beginning in 2010, as provided in IRS Notice 2009-97. However, Notice 2010-77 generally extended the deadline by one year. As with the original one-year extension provided in Notice 2009-97, the additional one-year extension does not apply to amendments that would eliminate a plan’s lump-sum whipsaw provisions.

In keeping with standard rules for amending plans to conform with regulatory changes, amendments should be adopted:

- in the case of required amendments, by the due date of the employer’s tax return for the plan year in which the change first becomes effective, or
- in the case of optional amendments, by the end of the plan year in which the change first applies, or
- in the case of an amendment that reduces future benefits, before the beginning of the first plan year in which the reduction will apply.

Practice Tip: We expect that most plan sponsors will want to wait until final market rate rules are provided, we hope, in 2011, to adopt any plan amendment that may be necessary to change a non-compliant interest crediting rate to a rate that meets final guidance. Employers then can evaluate the effect of the final rules on the market-rate limits and the associated anti-cutback relief that IRS said it expects to provide.

**New Terms**

The final regulations create the following new terms to describe the application of the new rules:

**Accumulated Benefit.** The term “accumulated benefit” refers to the benefit a participant has accrued to date as expressed under the terms of the plan. An example of an accumulated benefit would be the current value of a participant’s cash balance account. The accumulated benefit, which is different from a participant’s accrued benefit, does not include benefits that the participant has become entitled to but that have not yet been credited to the participant’s account. The term “accumulated benefit” does not include future interest credits on the pay credits that a participant already has accrued.

**Lump Sum-Based Benefit Formula.** “Lump sum-based benefit formula” describes a benefit formula expressed as the current balance of a participant’s hypothetical account, as in a cash balance plan, or the current value of the accumulated percentage of a participant’s final average compensation, as in a pension equity plan. In identifying whether a formula is a lump sum-based benefit formula, the determining factor is not the forms of payment available under the plan but rather how a participant’s benefit is expressed under the plan. For example, a cash balance formula would be a lump sum-based formula even if it did not permit lump sum distributions of the hypothetical accounts.

The final regulations clarify that benefits attributable to after-tax, rollover, or similar contributions are to be disregarded when determining whether a benefit formula is a lump sum-based benefit formula. A traditional
pension plan that provides a minimum benefit equal to a participant’s contributions as an employee is not a lump sum-based benefit formula.

**Statutory Hybrid Benefit Formula.** “Statutory hybrid benefit formula” refers to a lump sum-based benefit formula or formula that has an effect similar to that of a lump sum-based benefit formula. Generally, the term covers benefit formulas in which:
- periodic adjustments are made to a participant’s benefit,
- the right to future adjustments accrues at the same time as the benefit that is subject to the adjustments, and
- the total dollar amount of the adjustments is reasonably expected to be smaller for the participant when compared with the dollar amount for a similarly situated, younger individual who is or could be a participant.

The term statutory hybrid benefit formula does not cover benefit formulas with post-annuity starting date adjustments, such as cost-of-living and post-normal retirement age actuarial adjustments. Variable annuity benefit formulas with assumed interest rates of at least 5 percent also are not statutory hybrid benefit formulas.

**Reader note:** In this overview, we refer to statutory hybrid benefit formulas as “hybrid formulas,” and we refer to plans with hybrid formulas as a “hybrid plans.”

**General Age Discrimination Rules**

The final regulations implement PPA’s safe harbor rules under which a hybrid plan may be deemed to comply with an existing rule that prohibits the reduction of accruals on the basis of age.

**General Rule.** Tax code Section 411(b)(1)(H) provides that a defined benefit plan will violate age discrimination rules if a participant’s benefit accrual stops or the rate of benefit accrual is reduced because the participant reaches a certain age. Some litigants have argued that hybrid plans might violate the age discrimination rules because a credit made to a younger participant’s account is more valuable than the same credit made to an older participant’s account, primarily because of the additional years of interest until normal retirement age that will accrue for the younger participant.

**Safe Harbor Rule.** PPA added a new tax code Section 411(b)(5)(A), effective June 29, 2005, which creates special age discrimination rules for hybrid plans that take into account the nature of hybrid formulas. The statute states that “a plan shall not be treated as failing to meet the requirements of the general rule described above if a participant’s accrued benefit, as determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant.”

The final regulations describe a safe harbor method for complying with the general age discrimination rules. To qualify for the safe harbor, a participant’s accumulated benefit can never be less than the accumulated benefit of a similarly situated younger participant. The final regulations state that comparisons of accumulated benefits must be based on:
- an annuity payable at normal retirement age or at the participant’s current age, if that is later,
- the balance of a hypothetical account, or
- the current value of an accumulated percentage of a participant’s final average compensation as applicable, based on how the terms of the plan express the benefit.

If a plan expresses the benefit in any manner that differs from any of those three listed options, then the safe harbor is not available. Also, any comparisons of two individuals must be made by comparing the same form of benefit. For example, a participant whose benefit is expressed under the plan as an annuity may not be compared with a participant whose benefit is expressed under the plan as a hypothetical account.

**Similarly Situated.** The statute states that similarly situated individuals are two people who, other than in age, are identical in every respect that is relevant to determining benefits, such as length of service, compensation amount, position, date of hire, and work history. The final regulations state that any characteristic directly or indirectly based on age is to be disregarded in determining benefits. For example, if the benefit formula applies to a particular participant is determined based partly on the person’s age, then age is not to be considered in determining whether individuals are similarly situated.

The final regulations do not give examples of characteristics that might be indirectly based on age. Presumably any benefit based on eligibility for early retirement other than Social Security or early retirement subsidies, which are specifically excluded, would be indirectly based on age. Although higher service numbers might loosely correlate with age, presumably any benefit based on the attainment of a specified number of years of service would not be indirectly based on age.

**First Example:** John, age 45, and Julie, age 35, both participate in a cash balance plan. John and Julie were hired on the same date, both have been with their employer for 10 years, both earn $50,000, and both are assistant managers. John and Julie are similarly situated. Therefore, for the plan to satisfy the age discrimination safe harbor requirements, John’s benefit under the plan, as of any date on which the two are similarly situated, cannot be less than Julie’s benefit.

Assume that because Julie’s branch (branch A) has better performance than John’s branch (branch B), the employer decides to amend the plan to give branch A higher pay credits than branch B. Because the difference in pay credits is based on performance and location, and not age, the unequal pay credit are permissible. And because John and Julie are no longer similarly situated, Julie’s higher plan benefit will not cause the plan to fail the safe harbor test.

**Second Example:** Assume instead that the employer, desiring to retain younger employees, decides to give higher pay credits to all employees who are more than 15 years away from reaching early retirement age, which is age 55. Julie will receive the higher pay credits, but John will not. Because the basis for determining benefits is age in this example, John and Julie will remain similarly situated, and Julie’s higher plan benefit will cause the plan to fail the safe harbor test.

**Multiple Formulas.** The final regulations describe the application of the age discrimination safe harbor rule to a plan with more than one benefit formula, including its application in cases in which an older participant is permitted to choose between a hybrid formula and an existing traditional formula at the time a new hybrid for-
Formulas With Offsets or Social Security Integration. The final regulations incorporate the provisions of tax code Section 411(b)(5)(C) and (D) without additional explanation. The first provision states that having an offset against plan benefits, such that accruals under one plan are offset by benefits received under another plan, will not by itself violate the age discrimination rules to the extent that the offset meets the applicable requirements under tax code Section 401(a), the Age Discrimination in Employment Act, and the Employee Retirement Income Security Act.

The second provision, which concerns benefit formulas that are integrated with Social Security, states that formulas with offsets will not cause a plan to violate the age discrimination rules to the extent that the formulas comply with the permissible disparity rules in Section 401(l).

Suspension of Benefits. The final regulations include a new example to illustrate that the safe harbor rule is violated if a plan contains a suspension of benefits provision that reduces or eliminates interest credits for participants who continue in service after normal retirement age.

Indexed Benefits. The final regulations incorporate the provisions of tax code Section 411(b)(5)(E), which provides that certain indexing of benefits in non-lump sum benefit formulas will not cause a plan to fail the general age discrimination test. The statute and the regulations clarify that indexing means the periodic adjustment of the accrued benefit by applying a recognized investment index or methodology.

The final regulations provide that any rate of return that complies with the market-rate-of-return rules is a permissible index for purposes of adjusting accrued benefits. Plans that use indexing must compare the aggregate periodic adjustments determined as a percentage of the unadjusted accrued benefit. A safe harbor is available if the indexing is not terminated or reduced on the basis of age.

The final regulations also incorporate a “protection against loss” rule, which is applied in the same way that a preservation of capital rule is applied. An exception to the protection against loss rule applies to variable annuity benefit formulas.

Market-Rate-of-Return Limits for Interest Credits

General Rule. PPA added new tax code Section 411(b)(5)(B)(i), which provides that a hybrid plan will fail the age discrimination test unless it uses an interest crediting rate that is not greater than a market rate of return. The statute does not prohibit a plan from establishing a reasonable minimum guaranteed rate of return or from using the greater of a fixed or variable rate of return. That statutory change generally was effective for plan years beginning after Dec. 31, 2007. For plans not in existence on June 29, 2005, the change was effective June 29, 2005.

Definition of Interest Crediting Rate. The final regulations broadly define the phrase “interest crediting rate” as the rate at which a participant’s benefit is increased under the plan to the extent that the increase is not conditioned on current service.

The final regulations define an “interest credit” as any periodic increase or decrease in a participant’s accumulated benefit under a statutory hybrid benefit formula. The interest credit is calculated by applying a rate of interest or rate of return and any other increase or decrease, to the extent that the increase or decrease is not conditioned on current service and is not made on the basis of imputed service.

An increase is not considered to be an interest credit to the extent that an increase is made because of a plan amendment that provides for a one-time adjustment to the participants’ accumulated benefit. However, a pattern of repeated amendments to adjust benefits could be treated as a permanent plan feature.
Accordingly, interest-type credits that are conditioned on current service at the time they are made would be considered to be additional benefit accruals for purposes of other qualification requirements, such as complying with anti-backloading and nondiscrimination rules. For example, some cash balance plans may provide an additional interest credit on top of the normal credit for years during which the participant is employed.

**Market Rate of Return.** The final regulations list a number of interest indices that will be deemed to be not in excess of a market rate of return, including:

- the safe harbor rates for various Treasury bond rates with stated associated margins listed in IRS Notice 96-8,
- the interest rate on 30-year Treasury securities,
- the first-, second-, and third-segment bond rates applicable under tax code Sections 417(e) or 430, determined with or without the transition rules described in those sections, and
- eligible cost-of-living indices provided under the minimum required distribution rules, with up to 300 additional basis points.

In the case of a plan with annuity contracts, the final regulations generally allow the use of the rate of return on an employee's annuity contract.

**Additional Permissible Rates Proposed**

The proposed regulations would add the following additional permissible rates:

**Fixed Rates.** The proposed regulations would allow a hybrid plan to use a fixed rate of interest of up to 5 percent.

**Rate of Return on Plan Assets.** The proposed regulations would permit an interest crediting rate to be based on the actual rate of return on the aggregate assets of the plan, including both positive and negative returns, but only if the plan's assets are diversified to minimize the volatility of returns. The proposed regulations would require no greater diversification than necessary under ERISA’s plan investment diversification rules.

**Rates of Return Based on Mutual Funds.** The proposed regulations would allow the interest crediting rate to be based on returns from mutual funds offered by registered investment companies (RICs) if a mutual fund’s return is reasonably expected to be “not significantly more volatile” than the broad U.S. equities market or a similarly broad international equities market.” The proposed rules would not allow a market rate of return to be based on returns from mutual funds offered by a RIC that:

- has most of its assets invested in securities of issuers concentrated in an industry sector or a country other than the United States,
- uses leverage, or
- has significant investments in derivative financial products.

The proposed regulations would allow a market rate of return to be based on investments that track the rate of return on broad indexes such as the S&P 500, a small-cap index such as the Russell 2000 index, or an international equities index.

**‘Greater of’ Rates** The proposed regulations would permit the use of the greater of two rates of return only in limited circumstances in which each pair of rate options includes a fixed-rate floor or a cumulative floor, as in the following examples:

- the greater of an acceptable bond-based rate, determined on an annual or more frequent basis, and a fixed-rate floor of up to 4 percent, and
- the greater of an acceptable equity- or bond-based rate and a cumulative floor of up to 3 percent applied at the time a participant’s benefit is distributed.

Floor rates are important because they can be used to ensure that a plan with a graduated pay credit schedule will satisfy anti-backloading rules.

**Practice Tip:** The final regulations clarify that lower interest-crediting rates are permitted as an alternative to ‘greater of’ rates, provided they do not exceed one of the designated market rates. For example, a plan can use rates based on the ‘lower of’ two rates if at least one of the rates does not exceed the market-rate-of-return limits.

**Capital Preservation.** With tax code Section 411(b)(5)(B)(i)(II), PPA established a preservation of capital rule under which interest credits cannot result in an account balance being less than the aggregate amount of allocations other than interest crediting amounts. The final regulations clarify that this rule is to be applied only once, at the participant’s annuity starting date, with the result that the minimum interest crediting rate is effectively zero percent during the entire period that a person is a participant in the plan.

**Timing Issues.** The final regulations provide that a plan must state when it will determine the interest crediting rate using either the effective rate during the crediting period or, in the case of a bond-based rate, the rate for a specified look-back month applied to a specific stability period.

The look-back month and stability period must satisfy the requirements of Treasury Regulation Section 1.417(e)-1(d)(4), which for the stability period may be one calendar month, one plan quarter, one calendar quarter, one plan year, or one calendar year. The look-back month may be the first, second, third, fourth, or fifth full-calendar month preceding the first day of the stability period or an average of two or more consecutive permissible look-back months.

The look-back months need not be the same as those used under the plan for valuing lump sums under tax code Section 417(e)(3), but the interest rate must be determined at least annually.

A plan also must specify how often interest credits are allocated, which must be at least annually. If interest credits are allocated more frequently, the interest credit for the period must be no greater than a pro-rata portion of the annual interest credit. For example, a plan that makes interest credits monthly and has an annual interest rate of 6 percent may calculate the monthly credits based on a rate of 0.5 percent. Compounding of interest will not cause an otherwise permissible rate to exceed the market-rate-of-return limits.

**Practice Tip:** The proposed regulations indicate that a plan is not required to credit interest on amounts distributed before the end of the plan’s interest crediting period. The proposed regulations also contain rules on how cash balance plan accounts should be adjusted...
when a participant has more than one benefit commencement date.

Application to Pension Equity Plans. The final regulations provide that a pension equity plan (PEP) benefit formula that credits interest after a participant’s accruals generally have ceased is considered to be a lump sum-based benefit formula at that point, and the plan must comply with market-rate-of-return limits for interest credits.

The interest-crediting rules would apply to a terminated participant who has not yet received a distribution. It is less clear how the regulations would apply if, at all, to a PEP in which there is no interest adjustment after accruals cease.

The preamble to the proposed regulations invites comments on whether those types of PEPs should be excluded from the definition of a statutory hybrid plan.

Plan Termination. The proposed regulations provide details about interest and mortality assumptions that must be used in determining benefits when a hybrid plan is terminated. PPA generally provides that, when a hybrid plan is terminated, a plan that used a variable rate to determine interest credits must value benefits by using the previous five-year average of its variable rate. The proposed regulations generally reflect this rule, but they also provide that if the plan’s interest rate is based on a permissible rate that is not one of the bond-based rates, the prior five-year average rate should be based on the third segment bond rate under tax code Section 430(h)(2)(C)(iii) and not on the plan’s actual prior rates.

Cutback Issues. The final regulations generally provide that when a participant is entitled to future interest credits, any amendment to change the interest-crediting rate applicable to accrued benefits is a prohibited cutback if the revised rate under any circumstances could result in a lower interest crediting rate on any date after the amendment.

There is an exception for plans changing from a designated safe harbor market rate to a corporate bond designated market rate, provided that the effective date is at least 30 days after the adoption of the amendment and the new interest rate is not lower than the existing rate under the plan on the effective date.

The preamble to the proposed regulations states that expected future guidance will provide additional cutback relief by allowing a plan to change its crediting rate from an above-market rate to a market rate. The preamble also invites comments on how to establish parameters for determining how a plan can be changed to comply with the market rate requirements. For example, should a plan with a current rate in excess of a market rate be permitted to move to any of the permissible bond rates with the maximum permitted margin? Or should the ability to change depend on the reasons that the pre-amendment rate exceeded a market rate?

Anti-Wear-Away Protections for Plan Conversions

General Rule. Many sponsors of plans with traditional formulas converted to hybrid formulas by converting the benefit accrued under the traditional formula to an amount that was used as the opening balance under the hybrid formula. PPA added new tax code Sections 411(b)(5)(B)(ii), (iii), (iv) and (v) that create special rules for converting traditional plan formulas to hybrid plan formulas. If those rules are not followed, the hybrid plan will be deemed to violate age discrimination rules.

The statute was designed to prohibit interactions between the two formulas that result in “wear away.” The wear-away phenomenon occurs when a participant fails to earn additional benefits for some period of time after a conversion because the participant’s benefit under the new hybrid formula initially does not exceed the benefit the participant earned under the prior formula. To comply with the new rule, the plan terms must provide that a participant’s benefit will not be less than the sum of A plus B when:

- A is the accrued benefit for years of service as determined before the conversion, and
- B is the accrued benefit for years of service completed after the conversion.

The final regulations interpret the general rule and provide additional guidance on its application with several examples.

Application of the Rule. The conversion protection rule generally applies when a plan amendment results in a future reduction of traditional pension benefits and when, after the amendment is adopted, all or a portion of a participant’s future benefits are determined under a statutory hybrid benefit formula. A plan is treated as being amended for that purpose if, under the plan terms, a change in a participant’s employment would have the same effect as a conversion amendment. An example would be an employee who transfers from a position covered by a traditional formula to a position covered by a hybrid formula.

For purposes of the A plus B calculation:

- the two portions of the A plus B calculation must each be separately calculated as if they were separate plans,
- no offsets or other interactions may occur between the two formulas,
- any optional forms of payment that are available prior to the conversion must continue to be available for the portion of the benefit that relates to service earned before the conversion, and
- a participant’s right to receive any early retirement subsidy under the prior benefit formula must be preserved.

The final regulations permit a plan to convert an existing traditional benefit to an opening cash balance account if the plan treats the opening account balance as separate from the post-conversion account. When benefits are paid to a participant, the plan must ensure that the benefit attributable to the opening account is not less than the benefit, in the same form of distribution, under the pre-conversion plan terms on the date of conversion.

The proposed regulations would add another conversion option that would not require a comparison with the benefit under pre-conversion terms but instead would require specific opening account conversion rules, minimum interest-crediting rules, and special death-benefit provisions.

Effective Date. Under the statute, the A plus B conversion requirement applies to conversion amendments adopted after June 29, 2005. The final regulations indicate that a conversion amendment is covered by the
new rules only if it is adopted after, and takes effect after, June 29, 2005.

The final regulations also apply the conversion amendment rules on a participant-by-participant basis, so that the effective date of a conversion amendment for a particular participant is the date that benefits under the prior traditional benefit cease or are reduced for the participant.

However, if the plan terms that later resulted in the reduction were put in place by an amendment adopted prior to June 29, 2005, the conversion rules would not apply.

Consolidation Rules. The final regulations provide rules that would treat multiple plan amendments and multiple plans, including plans acquired in a business transaction, as subject to the conversion rules to the extent that the multiple amendments or plans have the effect of converting a participant’s benefit for use in a new hybrid formula. Multiple amendments made to one plan will be deemed to be subject to the conversion requirements if:

- the combined effect is to convert to a hybrid plan formula, and
- the amendments occur within three years of one another.

For example, if a plan is amended to freeze its traditional benefit formula and, within three following years, the plan is amended to implement a new hybrid formula, the earlier amendment will be treated as a conversion amendment.

Three-Year Vesting

PPA added new tax code Section 411(a)(13)(B) to require that participants become fully vested under a hybrid plan at the completion of three years of service. Under the final regulations, a determination of whether the three-year vesting rule applies is made on a participant-by-participant basis. If a participant’s accrued benefit is made up of two portions, a portion under a hybrid formula and a portion under a traditional defined benefit formula, the three-year vesting applies to a participant’s entire benefit under the plan.

Similarly, if a participant’s benefit is calculated as the greater of two formulas, one of which is a hybrid formula, the three-year vesting rule applies to the entire benefit, even if the non-hybrid formula provides a greater benefit.

A traditional pension plan having a floor-offset arrangement with a hybrid plan that includes a lump sum-based benefit formula is not subject to the three-year vesting schedule.

For plans in existence on June 29, 2005, the vesting change is effective for plan years on and after Jan. 1, 2008, even if the plan did not include a hybrid formula on June 29, 2005. For plans not yet in existence on June 29, 2005, the new vesting rule applies on the plan’s commencement date.

The three-year vesting rule applies to participants who have an hour of service after the applicable effective date. Special effective date rules apply to collectively bargained plans, under which the effective date could be as late as plan years beginning on or after Jan. 1, 2010.

Elimination of Whipsaw and Other Distribution Valuation Rules

Tax code Section 417(e) generally requires that lump-sum distribution amounts from defined benefit plans must equal at least the present lump-sum value of a participant’s normal retirement age benefit. IRS and courts generally have required cash balance plans to project a participant’s account balance to normal retirement age and discount that amount based on the participant’s age at distribution using the interest and mortality assumptions applicable under Section 417(e).

If a plan’s cash balance interest crediting rate exceeds the rate under Section 417(e), the calculation would produce a whipsaw effect in which the minimum present value amount exceeded the participant’s account value.

PPA added new tax code Section 411(a)(13)(A), which eliminated the whipsaw so that the value of a lump sum distribution is always equal to the participant’s account value.

The final regulations generally provide that a hybrid plan can permit the present value of a participant’s benefit under a lump sum-based benefit formula to be equal to the participant’s account, as determined by the plan’s terms. A hybrid plan benefit that is not a lump sum-based benefit formula must still comply with the lump sum valuation rules generally applicable under Section 417(e).

The proposed regulations would provide a more detailed interpretation of the requirements that a plan’s lump sum-based benefit formula must meet before the plan can take advantage of the valuation rule.

The proposed regulations also generally provide that a hybrid plan that qualifies for relief from Section 417(e) for valuing lump-sum distributions is permitted to value other optional forms of distribution, including annuities as the actuarial equivalent, using reasonable actuarial assumptions of a then-current cash balance account or accumulated benefit.

The elimination of whipsaw was generally effective with respect to distributions made after Aug. 17, 2006. However, Notice 2007-6 said that for an existing plan that uses a whipsaw calculation, an amendment to eliminate the whipsaw can become effective no sooner than at least 30 days after the plan provides notice to participants under the notice requirements of ERISA Section 204(h).

Cutback relief for an amendment to eliminate whipsaw generally expired at the end of the first plan year beginning in 2009, in connection with special cutback relief provided under PPA.

Comments Due Jan. 12, 2011

The proposed regulations request comments by Jan. 12, 2011, on topics that indicate current IRS thinking about cash balance plans. Specifically, IRS asked for comments on the ability of employers to offer participants a menu of hypothetical investment options, including a life-cycle option, in which participants are automatically and incrementally transitioned at specific ages from a blended rate that is weighted toward equities to a rate that is weighted toward bonds. IRS also asked for comments on related plan qualification issues that may arise as a result of:
switching from one investment option to another,
situations where one of the bond indices or mutual funds underlying one of the investment options ceases to exist,
amending a plan to eliminate an investment option,
a participant’s election to switch from an investment option with a cumulative minimum to one without, or vice versa, and
a plan termination after which future interest must be assumed at a fixed rate.

**Next Steps**

The final regulations go a long way toward clarifying many knotty issues that have plagued cash balance plans for years. We expect the clarification provided by the new rules to result in more conversions and new adoptions of cash balance plans.

The proposed regulations address a number of difficult remaining issues for hybrid plans, especially in the area of market-rate-of-return limits. We expect numerous comments to be made on the regulations, and we believe opportunity exists for significant changes in some areas, including in the rules for anti-cutback relief that would apply to plans that must modify their interest-crediting rules. In the meantime, we encourage all hybrid plan sponsors to consider carefully how the final and proposed rules might affect their own plans.