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Cash Balance Plans: The Continuing Impact of the Pension Protection Act of 2006

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Introduction

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When President George W. Bush signed the Pension Protection Act of 2006 ("PPA") on Aug. 17, 2006, he added another chapter to a long saga regarding cash balance pension plans. Although the PPA provided clarity and certainty regarding the legality of cash balance plans, it also raised many questions regarding how the new rules would be applied. Since the PPA was enacted, the Treasury Department and the Internal Revenue Service have issued three sets of regulations, most recently issuing final and proposed regulations on Sept. 19, 2014. This report looks at how the IRS and Treasury have interpreted the PPA provisions to date, and provides an overview of remaining open issues, as well as some highlights of how case law in this area has evolved.

Our Story So Far

A cash balance plan is a defined benefit plan that expresses its benefits in terms of additions to an account balance and interest credits on that account balance. Because a cash balance plan does not define its benefit as an annuity commencing at normal retirement age, such a plan doesn't fit neatly within certain traditional defined benefit plan rules under the Internal Revenue Code of 1986, as amended (the "Code") and the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Other types of hybrid defined benefit plans also express their benefits in terms of a single sum, and these plans face similar issues in complying with traditional defined benefit plan rules.

Three aspects of the Code's defined benefit plan rules have proven to be particularly thorny for these plans:

- whether the benefit is inherently age discriminatory in violation of the rule that a defined benefit plan must not provide for a rate of accrual that decreases on account of age;
- how to apply the anti-backloading rules that generally prohibit a plan from providing a significant increase in the rate of accrual in the latter years of a participant's career;
- how to ensure that lump sum distributions meet the applicable minimum lump-sum valuation rules.

Prior efforts to apply these traditional defined benefit plan rules to cash balance and other hybrid plans through regulatory interpretation have disappointed both plan sponsors and plan participants. Courts have also stepped in, adding their own interpretation of how traditional defined benefit plan rules should apply to these plans. After many false starts, Congress attempted to clear the air with the passage of the PPA.

Pre-PPA Guidance

The regulatory agencies first addressed cash balance plans when the Treasury Department and IRS issued regulations in 1991 regarding the nondiscrimination rules under Code Section 401(a)(4). The preamble to the regulations implied that the IRS viewed cash balance plans as not age discriminatory. The IRS did not expressly address the application of the age discrimination rules to cash balance and other hybrid plans until 1999, when the Treasury Department and IRS announced that they were actively considering the issue of whether cash balance plan conversions were age discriminatory and that they were suspending further IRS determination letters on conversions to cash balance plans.[1] On Dec. 21, 2006, four months after the passage of the PPA, the IRS finally lifted the moratorium, and once again issued determination letters with respect to cash balance plans.

Before 2002, the only other Treasury and IRS guidance specifically on cash balance plans was proposed guidance issued in 1996 on the calculation of minimum lump sum distributions from cash balance plans. Notice 96-8[2] proposed rules for the calculation of lump sum distributions taking into account the interest rate that was used to credit earnings on a participant's cash balance account and the required minimum interest rate used to calculate lump sum distributions. If the interest rate used to credit earnings on a cash balance participant's account was not the same as the interest rate used to calculate the participant's lump-sum distribution (or a comparable interest rate outlined in the notice), then the lump-sum distribution would need to be higher than the account balance disclosed to the participant. This has been referred to as "interest rate whipsaw," since using an interest crediting rate that is greater than the rate of interest used to calculate lump-sum distribution results in a higher distribution than was anticipated. A number of courts have examined the whipsaw issue and followed the approach proposed in Notice 96-8, including several circuit courts.[3]

In 2002, the Treasury Department and IRS issued proposed regulations that generally provided that a cash balance formula and conversions to cash balance plans would not violate the age discrimination rules. The issuance of these proposed regulations engendered much media attention, with many older plan participants raising concerns about the effect of cash balance conversions on their expected retirement benefits. Plan sponsors, too, were displeased with the proposed regulations, because they required a more mathematical, administratively complex determination of whether a plan was age discriminatory, and some types of hybrid plans would fail these new tests. In 2004, through an amendment to an appropriations bill, Congress stopped the Treasury Department and IRS from implementing the proposed regulations and required that the Treasury Department provide Congress with a legislative proposal for providing transition relief in conversions from traditional pension plans to cash balance plans.[4] The Administration's fiscal year 2005 budget proposal included a proposal regarding cash balance and other hybrid plans and conversions to such plans, surprising both the pro-cash balance and anti-cash balance advocates. In June 2004, the Treasury Department and IRS announced that they would withdraw the proposed regulations, stating that "[t]his will provide Congress an opportunity to . . . address cash balance and other hybrid plan issues through legislation."[5]

Congress had taken a step-by-step approach to addressing cash balance issues. In 1999, Sen. William Roth (R-DE) introduced the Retirement Savings Opportunity Act, which included provisions that declared cash balance plans to be in compliance with age discrimination rules and provided relief from the "interest rate whipsaw" problem. Not many people would remember those provisions because, after a media fire-storm reporting plan participants' opposition to these proposals, Roth reintroduced the same bill a few days later without the cash balance provisions. What Congress did instead was address rules regarding participant notices under ERISA Section 204(h), so that plan participants could more fully understand the impact a conversion to a cash balance plan would have on their benefits. Congress enacted this change in 2001,[6] and the Treasury and IRS finalized regulations regarding ERISA Section 204(h) notice requirements in 2005.[7]

Of course, the courts have been active with cash balance plan litigation. Although a number of district court cases held that cash balance plans are not inherently age discriminatory,[8] a case involving IBM's cash balance plan received the most media attention. In that district court case,[9] the court found that the cash bal-

[1] 56 Fed. Reg. 47528 (Sept. 19, 1991).

[2] 1996-1 C.B. 359.

[3] *See, e.g., Berger v. Xerox Corp. Retirement Income Guarantee Plan*, 338 F 3d. 755, 30 EBC 2505 (7th Cir. 2003); *Esden v. Bank of Boston*, 229 F. 3d 154, 24 EBC 2761 (2nd Cir. 2000), *cert. dismissed*, 531 U.S. 1061 (2001), and *Lyons v. Georgia Pacific Salaried Employees Retirement Plan*, 221 F. 3d 1235, 24 EBC 2473 (11th Cir. 2000) *cert. denied*, 532 U.S. 967 (2001).

[4] Consolidated Appropriations Act, Pub. L. No. 108-199, § 205 (2004).

[5] IRS Announcement 2004-57, 2004-27 I.R.B. 15.

[6] Economic Growth and Tax Relief Reconciliation Act (Pub. L. No. 107-16) § 659(b) (2001).

[7] Treas. Reg. § 54.4980F-1 (2005).

[8] *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000); *Godinez v. CBS Corp.*, No. SA CV 01-28-GLT (ANx), 31 EBC 2218 (C.D. Cal. May 20, 2002), aff'd by judgment order, No. 02-56148, 31 EBC 2221 (9th Cir. November 21, 2003); *Engers v. AT&T Corp.*, No. 98-3660 (NHP) (D.N.J. June 6, 2001); *Register v. PNC Fin. Servs. Group*, 477 F.3d 56, 39 EBC 2409 (3d Cir. 2007); *Hurlic v. Southern California Gas Co.*, No. 05-CV-5027 (C.D. Cal. Jan. 24, 2006) (order dismissing claim); *Campbell v. Bank of Boston, N.A.*, 327 F.3d 1, 30 EBC 1001 (1st Cir. 2003) (dictum); *Custer v. S. New Eng. Tel. Co.*, No. 3:05cv1444 (SRU), 42 EBC 2479 (D. Conn. Jan. 25, 2008); *Tomlinson v. El Paso Corp.*, No. 04-cv-02686-WDM-MEH, 40 EBC 1787 (D. Colo. Mar. 22, 2007) *Sunder v. U.S. Bank Pension Plan*, No. 4:05CV01153 ERW, 40 EBC 1799 (E.D. Mo. Feb. 16, 2007).

[9] Cooper v. IBM Personal Pension Plan, 274 F. Supp. 2d 1010, 30 EBC 2511 (S.D. Ill. 2003).

ance plan formula itself was age discriminatory, because the court looked at similarly-situated participants' cash balance accounts as of normal retirement age and found that the youngest person had a greater benefit due to the longer time horizon for compounding interest through normal retirement age. Concerned about the impact of that case on cash balance plans, cash balance plan advocates looked to Congress to provide some certainty about the legal status of cash balance plans. Congress did address cash balance plans in the PPA and provided some amount of legal certainty regarding newly established cash balance plans. In an ironic turn, shortly after Congress passed the PPA, but before the President signed it into law, the Seventh Circuit overruled the district court in the IBM case.[10] The Second Circuit, Third Circuit, Sixth Circuit, Ninth Circuit, and Tenth Circuit have followed the Seventh Circuit.[11]

Post-PPA Regulations

On Dec. 28, 2007, the Treasury Department and IRS issued the first set of proposed regulations (the "2007 proposed regulations") addressing the PPA's rules applicable to cash balance and other hybrid defined benefit plans.[12] Subsequently on Oct. 19, 2010, the Treasury Department and IRS finalized regulations[13] (the "2010 final regulations") and issued additional proposed regulations[14] (the "2010 proposed regulations"). Most recently, on Sept. 19, 2014, the IRS issued additional final regulations (the "2014 final regulations"),[15] and proposed regulations regarding transition relief to comply with the 2014 final regulations (the "2014 proposed regulations").[16] The 2014 final regulations generally are effective for plan years beginning on and after Jan. 1, 2016. The 2014 proposed regulations would provide cutback relief for plans that need to be amended to change the existing interest crediting rate to a rate that is not in excess of the final market rate of return limits.

Current Regulatory Framework

The Cash Balance Plan Formula Is Not Age Discriminatory

Under the PPA, beginning on or after June 29, 2005, a defined benefit plan does not violate the age discrimination provisions under ERISA, the Code, and the Age Discrimination in Employment Act if, under the terms of the plan, a participant's accrued benefit is equal to or greater than the benefit of a similarly-situated younger person.[17] While the result of the legislation is the same as the 2002 proposed Treasury regulations, under the PPA there is no need to perform complicated mathematical calculations to determine whether the plan discriminates on the basis of age. One compares the benefit of a person with the same pay and years of service with someone who is younger. If the older person gets the same or better benefit, then the plan is not age discriminatory.

The PPA further states that subsidized early retirement benefits (or retirement-type subsidies) are not taken into account in determining the accrued benefit. In addition, benefit offsets permissible under Code Section 401(a) (*e.g.,* Social Security offsets) and pre-retirement indexing of a benefit do not violate the age discrimination rules.

The general rule in the Code prior to the PPA states that a defined benefit plan will not satisfy the age discrimination rules if a participant's benefit accrual is ceased, or the rate of benefit accrual is reduced, because of the attainment of any age.[18]

The 2010 and 2014 final regulations provide helpful guidance on the types of plans that will qualify for the age discrimination safe harbor added by the PPA. These are summarized below. If a hybrid plan does not meet the safe harbor requirements (either because it is not eligible for safe harbor comparison or because it fails to meet one or more of the requirements set out in the regulations), it is not automatically found to be age discriminatory. Rather, it then must meet the general rules applicable to defined benefit plans under Code Section 411(b)(1)(H). The existing regulations provide little insight into how the general rule might be applied to hybrid plans. However, much litigation, some of which is discussed later in the article, has revolved around whether hybrid plans (in particular, cash balance plans) violate the general age discrimination rule.

Safe Harbor

The final regulations describe a "safe harbor" manner of meeting this requirement, under which a participant's accumulated benefit could never be less than a similarly situated younger participant's accumulated benefit.[19] The final regulations provide that comparisons must be based on (1) an annuity payable at normal retirement age (or at current age, if later), (2) the current balance of a hypothetical account, or (3) the current value of an accumulated percentage of the 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 a manner other than these three listed options, then the safe harbor is not available. In addition, any comparison between two individuals must be made by comparing the same form of benefit (*i.e.*, a participant whose benefit is expressed under the plan as

[10] *Cooper v. IBM Personal Pension Plan*, 457 F.3d 636, 38 EBC 1801 (7th Cir. 2006).

[11] *Hurlic v. So. Cal. Gas Co.* 539 F.3d 1024, 44 EBC 1897 (9th Cir. 2008); *Hirt v. The Equitable Ret. Plan for Employees, Managers & Agents*, 533 F.3d 102, 44 EBC 1289 (2d Cir. 2008); *Drutis v. Rand McNally & Co.*, 499 F.3d 608, 41 EBC 1577 (6th Cir. 2007); *Register v. PNC Fin. Servs. Group, Inc.*, 477 F.3d 56, 39 EBC 2409 (3d Cir. 2007); *Tomlinson v. El Paso Corp.*, 653 F.3d 1281, 51 EBC 2740 (10th Cir. 2011).

[12] 72 Fed. Reg. 73,680 (December 28, 2007).

[13] 75 Fed. Reg. 64,123 (October 19, 2010).

[14] 75 Fed. Reg. 64,197 (October 19, 2010).

[15] 79 Fed. Reg. 56,442 (Sept. 19, 2014).

[16] 79 Fed. Reg. 56,302 (Sept. 19, 2014).

[17] ERISA § 204(b)(5), Code § 411(b)(5), and ADEA § 4(i)(10).

[18] Code § 411(b)(1)(H).

[19] Treas. Reg. § 1.411(b)(5)-1(b).

an annuity may not be compared to a participant whose benefit is expressed under the plan as a hypothetical account).

Similarly Situated

In order to address when individuals are "similarly situated" (*i.e.*, two individuals who are identical in every respect, other than age, that is relevant in determining benefits, such as length of service, compensation amount, position, date of hire, and work history), the final regulations indicate that any characteristic that is directly or indirectly based on age is disregarded.[20] For example, if the benefit formula applicable to a participant is determined based in part on the age of the participant, then that factor is not considered in determining whether individuals are similarly situated. The regulations do not give any examples or insight into what characteristics might be indirectly based on age. Presumably, any benefit based on eligibility for early retirement (other than early retirement subsidies, which are specifically excluded) or Social Security would be indirectly based on age. We also would presume that attainment of a specified number of years of service, although higher numbers may loosely correlate with age, would not be indirectly based on age.

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 meet the age discrimination safe harbor, John's benefit under the plan, as of any date while 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 has decided to give branch A higher pay credits than branch B. Because the difference here is based on performance and location, and not age, this difference is not disregarded. Therefore, John and Julie are no longer similarly situated, and Julie's higher plan benefit will not cause the plan to fail the safe harbor. Instead, assume that in the employer's attempt to retain younger employees, it decided to give higher pay credits to all employees who are more than 15 years away from reaching early retirement age (age 55). Julie will receive the higher pay credits, but John will not. Because this characteristic is based on age, John and Julie remain similarly situated, and Julie's higher plan benefit will cause the plan to fail the safe harbor.

Multiple Formulas

The final regulations also describe the application of the safe harbor to a plan with more than one benefit formula, including where an older participant is permitted to elect, at the time a new hybrid formula goes into effect, between the hybrid and an existing traditional formula.[21] If, under a plan, a participant's benefit equals the sum of benefits expressed as different forms, then the final regulations provide that the safe harbor is satisfied if each separate form of benefit would satisfy the safe harbor. For example, if a defined benefit plan were to freeze its traditional formula and add a new cash balance formula, the safe harbor would have to be met separately for the traditional formula and the cash balance formula. If a participant's benefit equals the greater of benefits under two or more different formulas (expressed under the plan in different forms), then the plan must separately satisfy the safe harbor for each separate form of benefit.

The final regulations specify that where different types of benefit formulas exist, the safe harbor rule generally cannot be met unless each formula available to younger participants is also available to older participants. This rule could present a problem for a plan sponsor that converts a traditional formula to a hybrid formula and wishes to grandfather older participants under the traditional formula without providing the hybrid benefit if greater. In such case, the characteristic of being grandfathered is disregarded because it is based on age, and grandfathered participants could be considered similarly situated to non-grandfathered participants. The hybrid formula would not pass the safe harbor because the formula is only available to younger, similarly situated participants. It appears that this problem could be avoided by basing the requirements for grandfathering only on factors other than age (for example, based on years of service), by giving the older group benefits under the greater of the traditional or hybrid formulas, or by extending choice to the older (or to all) participants.

Formulas with Offsets or Social Security Integration

The final regulations incorporate the following two provisions of Code section 411(b)(5)(C) and (D), without adding additional explanation. First, plan provisions for an offset against plan benefits (*i.e.,* when the accruals under one plan are offset by the benefits received under another plan) will not, by themselves, cause a plan to fail to satisfy the age discrimination prohibitions, to the extent that the offset meets the applicable requirements under Code section 401(a), ADEA, and ERISA.[22] The second item relates to benefit formulas that are integrated with Social Security.[23] These formulas will not cause a plan to violate the age discrimination rules where the formula meets the permitted disparity rules in Code section 401(l).

Suspension of Benefits

The final regulations (as modified by the 2014 final regulations) indicate that hybrid plans remain subject to the general requirements for post-normal retirement age ("post-NRA") adjustments and permitted suspension of benefits under Code section 411(a). Accordingly, a plan with a lump-sum based benefit formula must ensure that post-NRA benefits are sufficiently increased to satisfy the actuarial increase requirements or that a

[20] Treas. Reg. § 1.411(b)(5)-1(b)(5).
[21] Treas. Reg. § 1.411(b)(5)-1(b)(1)(ii).
[22] Treas. Reg. § 1.411(b)(5)-1(b)(3).
[23] Treas. Reg. § 1.411(b)(5)-1(b)(4).

proper suspension of benefits provision applies under Code Section 411(a)(3)(B).[24]

Indexed Benefits

The final regulations incorporate the provisions of Code Section 411(b)(5)(E), which provides that certain indexing of benefits in non-lump sum based benefit formula will not cause the plan to fail to satisfy the age discrimination requirements.[25] The statute and the regulations both clarify that indexing means the periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology. The final regulations provide that any rate of return that meets the market rate of return rules is a permissible index for this purpose. Rather than comparing the accumulated benefit, these plans must compare the aggregate periodic adjustments determined as a percentage of the unadjusted accrued benefit. The final regulations also incorporate the "protection against loss" rule, which is applied in the same way as the preservation of capital rule (described below under interest crediting). An exception to the protection against loss rule applies to variable annuity benefit formulas.

Court Decisions

Courts have generally accepted that cash balance plans are not inherently age discriminatory, consistent with the PPA.[26] As a result, current litigation regarding cash balance formulas discriminating on the basis of age has decreased in prevalence. Nevertheless, since the IRS has not provided guidance on how the age discrimination test will apply after the PPA, it is not entirely clear what happens for a plan that does not meet the safe harbor requirements of the PPA. Thus, the Seventh Circuit's *IBM* decision provides some helpful analysis for cash balance and other hybrid pension plans that may be subject the general age discrimination test.

Judge Easterbrook's opinion reversed the district court on both common-sense and technical grounds. From a common-sense perspective, the court observed that defined contribution plans are typically structured to provide, in a particular year, the same dollar allocation to all participants, without regard to age. Due to the time value of money, a younger participant's cash allocation will grow to a much larger account balance by normal retirement age than would the same cash allocation made to an older participant. "Why," the court asked, "should it become unlawful because the account balances [in a cash balance plan with age-neutral terms] are book entries rather than cash?" The court observed, "Treating the time value of money as a form of discrimination is not sensible."

The court backed up its common-sense observation through a technical review of statutory language and the Treasury Department's proposed (then withdrawn) regulations. The court observed that the term "benefit accrual" is not defined under federal pension law. Although ERISA and the tax code define an "accrued benefit" as an annuity commencing at normal retirement age, the court saw no reason to read the terms "benefit accrual" and "accrued benefit" as synonymous. Instead, the court concluded, "[t]he phrase 'benefit accrual' reads most naturally as a reference to what the employer puts in (either in absolute terms or as a rate of change), while the defined phrase 'accrued benefit' refers to outputs after compounding." Presumably, "what the employer puts in" is not the same as employer contributions, since contributions are governed by funding rules not directly tied to cash balance account credits, but rather refers to notional account increases under plan terms. Similarly, the court noted that the Treasury Department's proposed regulations also focused on "the rate of contribution (what goes into the account) rather than the annual rate of withdrawal at retirement." Though the regulations were withdrawn (due to an appropriations rider that prevented the Treasury from taking final action), the court noted that the proposed regulations could still "help to inform our understanding of the statute."

The court concluded its analysis with several broadly-applicable observations regarding retirement plan litigation, including age discrimination litigation:

Plaintiffs must demonstrate that adverse impact is actually on account of age. It is essential, the court noted, to separate age discrimination from other characteristics that may be correlated with age – a plaintiff "alleging age discrimination must demonstrate that the complained-of effect is *actually* on account of age." Here, the court concluded, differences in pension benefits for differently-aged participants "are a function of differing years of service, salary history, or the years the balance has been allowed to compound; age is not a factor."

Removing rules that favor older employees is not age discrimination. The court noted that a cash balance plan typically removes benefit backloading that is common to traditional pension formulas (where larger benefits typically accrue during a participant's final, most highly-paid, years). However, the court concluded, "removing a feature that gave extra benefits to the old differs from discriminating against them. Replacing a plan that discriminates against the young with one that is age-neutral does not discriminate against the old."

Pension law does not protect expectations. An employer, the court observed, "is free to move from one legal plan to another legal plan, provided that it does not diminish vested interests." That a change may have "disappointed expectations is not material." Accordingly, the court concluded, a cash balance plan that gives participants the greater of the present value of their frozen traditional benefit or the value of a cash balance formula applied to all participation years is permitted.

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[24] Treas. Reg. § 1.411(a)(13)-1(b)((2).

[25] Treas. Reg. § 1.411(b)(5)-1(b)(2).

[26] *See, e.g., Hurlic v. So. Cal. Gas Co.* 539 F.3d 1024, 44 EBC 1897 (9th Cir. 2008); *Hirt v. The Equitable Ret. Plan for Employees, Managers & Agents*, 533 F.3d 102, 44 EBC 1289 (2d Cir. 2008); *Drutis v. Rand McNally & Co.*, 499 F.3d 608, 41 EBC 1577 (6th Cir. 2007); *Register v. PNC Fin. Servs. Group, Inc.*, 477 F.3d 56, 39 EBC 2409 (3d Cir. 2007).

Note that the PPA and related final regulation now provide more restrictive rules related to cash balance plan conversion amendments – these are discussed in Section .30.50 below.

Private choice, not litigation, should govern the attractiveness of retirement plans. Litigation, the court stated, "cannot compel an employer to make plans more attractive." The appeals court criticized the district court for seeking, through litigation, to compel employers to make plans more attractive for participants, and noted that, instead, "litigation about pension plans" may "make everyone worse off." Here, the court noted, the district court's decision led IBM to replace its defined benefit plan with a pure defined contribution plan. The court proudly observed that, after its decision reversing the district court, "the decision [about retirement plan structure and attractiveness] may again be made freely, governed by private choice rather than legal constraint."[27]

Interest Rate Crediting

New ERISA Section 204(b)(5), Code Section 411(b)(5), and ADEA Section 4(i)(10) provide that existing hybrid plans must provide an interest crediting rate that is no greater than a market rate. The reason for this rule is that a high rate of return may be a substitute for the yearly crediting of amounts (*e.g.,* pay credits) to a cash balance account, and should be treated as such. Younger participants receive interest credits for a longer period; therefore, if they are essentially receiving extra pay credits compared to older participants, this could be viewed as age discriminatory. The PPA directs the Secretary of Treasury to define a "market rate" of return and prescribe methods for crediting interest to a participant's account. The PPA does not prevent the plan from establishing a minimum guaranteed rate of return or from using the greater of a fixed or variable rate. If an interest crediting rate is a variable rate, the plan must provide that, upon plan termination, the rate used to determine accrued benefits under the plan will be equal to the average of the interest rates used under the plan during the prior five years.

"Interest Credit" Definition

The final regulations define an "interest credit" as any increase or decrease for a period to a participant's accumulated benefit under a statutory hybrid benefit formula, that is calculated by applying a rate of interest or rate of return, as well as any other increase or decrease, to the extent the increase or decrease is not conditioned on current service and is not made on account of imputed service (in other words, an increase that is not a "pay" or "principal" credit).[28] An increase is not considered an interest credit to the extent the increase is made as a result of a plan amendment providing for a one-time adjustment to the participants' accumulated benefit, however, a pattern of repeated amendments to adjust benefits could be treated as constituting a permanent plan feature.[29] Accordingly, interest-type credits that are conditioned on current service (*e.g.,* some cash balance plans may provide an additional interest credit on top of the normal credit for years while the participant is employed) would be considered additional benefit accruals (*e.g.,* for purposes of other qualification requirements such as the anti-backloading and nondiscrimination rules) at the time they are made.

Market Rate of Return

The 2010 final regulations listed a number of interest indices that will be deemed to be not in excess of a market rate of return,[30] including (1) the safe harbor rates listed in IRS Notice 96-8 (consisting of various Treasury bond rates with stated associated margins), (2) the interest rate on 30-year Treasury securities, (3) the first, second and third segment bond rates applicable under Code Section 417(e) or 430 (determined with or without the transition rules described in these sections), and (4) eligible cost-of-living indices provided under the minimum required distribution rules with up to an additional 300 basis points. In the case of a plan with annuity contracts, the 2010 final regulations generally allow the use of the rate of return on the annuity contract for the employee.

The 2014 final regulations add the following additional rates:[31]

Fixed Rates. A plan may use a fixed rate of interest of up to 6 percent (up from 5 percent as would have been permitted by the 2010 proposed regulations).[32]

Rate of Return on Plan Assets. The interest crediting rate may 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 so as to minimize the volatility of returns (though this is to require no greater diversification than required under ERISA's plan investment diversification rules).[33]

A Subset of Plan Assets. The interest crediting rate may be based on the actual rate of return for a subset of a plan's assets. The subset must be diversified so as to minimize the volatility of returns, cannot hold qualifying employer securities and qualifying employer real property in excess of 10 percent of the fair market value of the subset's assets, and the fair market value of the assets must approximate the liabilities that are adjusted by the subset's rate of return (determined using reasonable actuarial assumptions).[34]

Rates of Return Based on Mutual Funds (i.e., Registered Investment Companies, or "RICs"). The interest crediting rate may be based the rate of return of a mutual fund if it is reasonably expected to be "not significantly more volatile than the broad United States

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[27] *Cooper v. IBM Personal Pension Plan*, supra.
[28] Treas. Reg. § 1.411(b)(5)-1(d)(1)(ii)(A).
[29] Treas. Reg. § 1.411(b)(5)-1(d)(1)(ii)(B).
[30] Treas. Reg. § 1.411(b)(5)-1(d)(1)(iii).
[31] Treas. Reg. § 1.411(b)(5)-1(d).
[32] Treas. Reg. § 1.411(b)(5)-1(d)(4)(v).
[33] Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii)(A).
[34] Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii)(B).

equities market or a similarly broad international equities market." This would not include a RIC that (i) has most of its assets invested in securities of issuers concentrated in an industry sector or a country other than the United States, (ii) uses leverage, or (iii) has significant investment in derivative financial products. On the other hand, a RIC whose investments track the rate of return on the S&P 500, a broad-based "small-cap" index (such as the Russell 2000 index), or a broad-based international equities index, would be permissible.[35]

Greater-of Rates. A plan may use the greater of two rates in only limited circumstances:

- *Annual Floors for Bond-Based Rates*. The 2014 final regulations allow the greater of an acceptable rate (determined on an annual or more frequent basis), and a fixed-rate floor. For rates of return based on the segment rates in 417(e) or 430, a fixed-rate floor of up to 4 percent is permitted. For rates of return based on government bonds or an applicable cost of living index, a fixed-rate floor of up to 5 percent is permitted (up from 4 percent as would have been permitted under the 2010 proposed regulations).[36] Floor rates are important because they are sometimes used to make sure that a plan with a graduated pay credit schedule will satisfy the anti-backloading rules.
- *Cumulative Floors for Bond or Equity-Based Rates*. The 2014 final regulations allow a cumulative floor of up to 3 percent to be used with any permissible rate of return. The cumulative floor is to be applied at the time of a participant's distribution of benefits.[37]

In the preamble of the 2014 final regulations, the IRS noted that it received many comments in support of participant-directed cash balance designs.[38] The IRS noted various legal concerns raised by such a design and indicated that it will continue to study these issues. The IRS suggested that, if it does not conclude that participant-directed designs are not permitted, plans which currently provide for participant direction among a menu may qualify for anti-cutback relief.[39]

Lower Rates

The final regulations indicate that lower rates are permitted, provided at least one of the rates does not exceed a designated market rate.[40] For example, a plan could provide interest rates based on the lower of two rates, provided that at least one of the rates meets the market rate limitation.

Capital Preservation

With Code Section 411(b)(5)(B)(i)(II), the PPA established a preservation of capital rule, which states that interest credits cannot result in an account balance being less than the aggregate amount of allocations other than interest crediting.[41] The 2014 final regulations clarify that this rule is applied once—at the participant's annuity starting date. This means that the minimum interest crediting rate is, in effect, zero percent over the entire period of an individual's participation in a plan. In addition, the 2014 final regulations provide that a participant who has five one-year breaks in service, after receiving a complete distribution of his or her benefit under the plan, may have the prior distribution disregarded for purposes of the capital preservation requirement.[42]

Timing Issues

The final regulations provide that a plan must state when it will determine the interest crediting rate[43]—using either the effective rate during the crediting period or, in the case of a bond-based rate, the plan is permitted to determine the rate for a specified lookback month to be applied over a specified stability period. The lookback month and stability period must satisfy the requirements of Treas. Reg. § 1.417(e)-1(d)(4) (*i.e.,* the stability period may be one calendar month, one plan quarter, one calendar quarter, one plan year, or one calendar year, and the lookback 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 permitted lookback months), but they need not be the same as those used under the plan for valuing lump sums under Code Section 417(e)(3). The interest rate must be determined at least annually.

In addition, the plan must specify how often interest credits are allocated (not less frequently than annually). If they are made more frequently than annually, then 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 .5 percent). Compounding of interest will not cause an otherwise permissible rate to exceed the market rate of return limitation. A plan is not required to credit interest on amounts distributed prior to the end of the plan's interest crediting period.

Plan Termination

The final regulations require certain interest and mortality assumptions for determining benefits when a hybrid plan is terminated.[44]

Interest Crediting Rate. The PPA generally provides that, upon termination, a hybrid plan that used a variable rate to determine interest credits must value benefits by using the previous five-year average of its variable rate.[45] The final regulations generally reflect this rule, but provide that where the plan's interest rate

[35] Treas. Reg. § 1.411(b)(5)-1(d)(5)(iv).
[36] Treas. Reg. § 1.411(b)(5)-1(d)(6)(ii).
[37] Treas. Reg. § 1.411(b)(5)-1(d)(6)(iii).
[38] 79 Fed. Reg. 56455–56.
[39] 79 Fed. Reg. 56456
[40] Treas. Reg. § 1.411(b)(5)-1(d)(1)(v).
[41] Treas. Reg. § 1.411(b)(5)-1(d)(2).
[42] Treas. Reg. § 1.411(b)(5)-1(d)(2)(ii)(C).
[43] Treas. Reg. § 1.411(b)(5)-1(d)(1)(iv).
[44] Treas. Reg. § 1.411(b)(5)-1(e)(2).
[45] Code § 411(b)(5)(B)(vi)(I).

was based on a permitted rate that is not one of the bond-based rates (*e.g.,* where the plan's interest is based on the return of plan assets, an annuity contract, or a mutual fund), the prior five-year average of the second segment bond rates under Code Section 430(h)(2)(C)(ii) should be substituted for the plan's actual prior rates.[46] The substituted rates are adjusted to account for any minimums or maximums that applied to the period, but not for other reductions in that period.[47] Any cumulative floor that may apply for the rates of return is disregarded for applying the five-year average, but still will apply for determining a participant's benefit on the annuity starting date. *Id*. Generally, the five-year average is weighted for the length of each crediting period.

Mortality Table. If the plan used a mortality table in conjunction with an interest rate to convert a participant's accumulated benefit into an annuity for the entire five-year period before the plan termination date, then the mortality table and interest rate used to determine any annuity benefits payable after the plan termination date must be the same table specified under the plan as of the date of plan termination.[48] If the mortality table has any projected mortality improvement incorporated under the plan terms, the improvements must be projected through the participant's annuity starting date.[49] When a plan has not used a mortality table to determine annuity benefits for the entire five-year period, the average of the mortality tables used by the plan will apply for post-termination annuity benefits.[50]

Tabular Mortality Factors. If the plan used the same tabular mortality factors (*i.e,*. single conversion factors that account for interest and mortality) to determine annuity benefits for the five-year period ending on the date of plan termination, the plan must use the same tabular factors to determine annuity benefits that commence after the date of plan termination. If the plan changed its factors within the five-year period, the average of the factors used under the plan in that period must be used.[51]

Optional Forms. A plan may specify a different conversion basis for different optional forms. The final regulations require that the five-year averaging upon plan termination should be applied separately to each optional form.[52]

Pension Benefit Guaranty Corporation (PBGC) Proposed Regulations. In 2011, the PBGC proposed regulations to address valuing the benefits of hybrid plans during the termination process.[53] Generally, the proposed regulations were intended to incorporate the termination requirements of Code Section 411(b)(5)(B)(vi). To that extent, the PBGC proposed regulations provided how to determine interest credits for a hybrid plan after its termination date by generally using the arithmetic average of the interest crediting rates during the five-year period prior to the termination date. The PBGC proposed regulations also provided that in the case of a variable rate determined using the rate of return for plan assets, a subset of plan assets, or mutual funds, or in the case of plan using an impermissible interest crediting rate, that on and after the plan termination date the PBGC would determine interest credits by applying the third segment rate under Code Section 430(h)(2)(C)(iii) for the last calendar month ending before the interest crediting period. Because of the changes in the IRS guidance on interest crediting rates, one would expect that the PBGC would update its proposed regulations on interest credits used after a plan termination to be consistent with the IRS guidance.

Cutback Restrictions – In General

The 2010 final regulations generally provided that an amendment to change the interest crediting rate applicable to accrued benefits (*i.e.,* where the participant is already entitled to future interest credits) is a prohibited cutback if the revised rate "under any circumstances" could result in a lower interest crediting rate as of any date after the amendment.[54] There is an exception for plans changing from a designated safe harbor market rate to the 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 2014 final regulations allow a plan to change the lookback month and/or stability period used to determine interest credits, but the plan must credit the greater of the old and new approaches for a one-year transition period.[55] Also, if a plan uses a designated RIC as the basis for interest credits, and that RIC ceases to exist, the final regulations allow the plan to designate a successor RIC, without any special cutback protections, provided that the successor RIC is the RIC that results from a name change or merger of the original RIC, or, in other cases, the new RIC has reasonably similar characteristics, including risk and return characteristics, as the RIC that no longer exists.[56]

Cutback Relief for Required Changes

The 2014 proposed regulation would provide "cutback" relief to allow a plan to comply with the final market rate limitations.[57] The relief would allow changes to the interest credits on benefits that have already accrued. Generally, to qualify for the relief, plans would need to adopt corrective amendments no later than prior to the first day of the first plan year beginning on or after Jan. 1, 2016. If a plan has multiple noncompliant feature (*e.g.,* crediting rate is an above-market rate, and uses an

46 Treas. Reg. §§ 1.411(b)(5)-1(e)(2)(ii)(A), (B)(2).
47 Treas. Reg. § 1.411(b)(5)-1(e)(2)(ii)(C).
48 Treas. Reg. § 1.411(b)(5)-1(e)(2)(iii)(A).
49 Treas. Reg. § 1.411(b)(5)-1(e)(2)(iii)(A)(2).
50 Treas. Reg. § 1.411(b)(5)-1(e)(2)(iii)(C).
51 Treas. Reg. § 1.411(b)(5)-1(e)(2)(iii)(B).
52 Treas. Reg. § 1.411(b)(5)-1(e)(2)(iii)(D).
53 76 Fed. Reg. 67105 (October 31, 2011).

54 Treas. Reg. § 1.411(b)(5)-1(e)(3).
55 Treas. Reg. § 1.411(b)(5)-1(e)(3)(iv)(A).
56 Treas. Reg. § 1.411(b)(5)-1(e)(3)(v).
57 Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(vi).

impermissible lookback period), each change would need to be addressed separately. The 2014 proposed regulations proscribes the following corrective actions:

Excessive Fixed Rate. If the fixed rate is in excess of six percent, the plan must be amended to reduce the rate to six percent.[58] The proposed rule does not state that any lower fixed rate may be used.

Excessive Margins. If a bond-based rate uses an excessive margin, the plan must be amended to use the maximum permissible margin.[59]

Excessive Floor. If the bond-based rate uses an excessive floor to provide interest credits, the plan must be amended either to reduce the floor rate level, or to use a fixed rate of six percent.[60]

Composite Bond Rate. If the plan credits interest by reference to the greatest of two or more of the "permitted" bond rates (*i.e.,* Code Section 417(e) segment rates, government bonds, or an approved cost of living index), the plan must be amended to use the lesser of the composite rate and the third segment rate under Code Section 417(e).[61]

Impermissible Bond-Based Rate. If a variable bond-based rate is used that is not an approved investment-based rate of return for bonds (*i.e.,* not described in paragraphs (d)(3) or (d)(4) of the 2014 final regulations), the plan must be amended to use a permissible variable rate that has similar duration and quality characteristics as the existing variable bond rate.[62] If no such bond rate exists, then the rate must be lesser of the plan's existing rate and the third segment rate under Code Section 417(e).

Impermissible Investment-Based Rate. If an impermissible investment-based rate is used (*i.e.,* not described in paragraph (d)(5) of the 2014 final regulations, then plan must be amended to a rate that has similar risk and return characteristics as the impermissible investment rate.[63] If no such rate exists, then the plan must use the return on plan assets, the return of a subset of plan assets, or the return of a mutual fund.

Plan Investment Considerations

Because cash balance and other hybrid plans are types of defined benefit plans, the funding and investment of plan assets should be overseen in a manner to meet the plan's benefit obligations, like other defined benefit plans. However, the hybrid nature of the benefit formula, and the plan's interest crediting rate approach, may impact the investment strategy. For example, for a cash balance plan that uses an outside variable index (bond-based or RIC based) for determining interest credits, it may be fairly straight-forward to implement a liability-driven investment strategy to approximate the underlying interest credit index.

[58] Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(vi)(C)(2).
[59] Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(vi)(C)(3).
[60] Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(vi)(C)(4).
[61] Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(vi)(C)(5).
[62] Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(vi)(C)(6).
[63] Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(vi)(C)(7).

As noted above, the final regulations permit a cash balance plan to provide interest credits based on the investment return of plan assets, or based on the return of a subset of plan assets. Under these designs, the participants' ultimate benefit from the plan will be directly impacted by the actual investment return of plan assets. This is different from most other defined benefit plans, where the participants' benefit from the plan bears no relationship to the underlying investment return of plan assets (with the possible exception of severely underfunded plans that are taken over by the PBGC). As a result, these types of plans may well subject the plan's investment decision-makers to fiduciary breach claims made by participants who believe the investment decisions made had a negative impact on the amount of their benefit.

Application to Pension Equity Plans (or "PEPs")

A "Pension Equity Plan" or "PEP" generally refers to a plan with a benefit formula that produces a current lump-sum amount based on an aggregate service-based percentage (*e.g.,* 10 percent for each year of service), multiplied by the participant's final average compensation.

The final regulations provide some limited guidance on how PEPs—an area long devoid of any guidance—are to be treated under the hybrid plan rules.

Most PEPs Subject to Hybrid Plan Rules

Generally, plans that express benefits as the current balance of an accumulated percentage of a participant's final average compensation or as a percentage of the participant's highest average compensation will be considered a "lump sum-based benefit formula"[64] subject to all of the hybrid plan rules, including the beneficial age discrimination safe harbor rules.

Permitted Reductions in PEP Balances

The final rules provide that a PEP benefit can decrease from one year to the next as a result of a decrease in the participant's final average compensation or as a result of an increase in the Social Security wage base where the benefit formula is integrated with Social Security.[65] It is unclear whether IRS has ever expressly acknowledged that a decrease in a participant's final average compensation can result in a permissible reduction in the participant's accrued pension benefit, consistent with vesting and anti-cutback requirements. This may be a helpful development for traditional final average pay plans as well.

Deferred PEP Plans

An offshoot of the PEP design is a pension plan formula that produces a lump-sum benefit amount at normal retirement age. For example, a plan may provide that a participant's benefit is equal to a lump-sum amount at normal retirement age equal to an accumulated percentage of the participant's final average compensation.

[64] Treas. Reg. § 1.411(a)(13)-1(d)(2).
[65] Treas. Reg. § 1.411(a)(13)-1(b)(2)(ii).

The final rules clarify that such a formula is not subject to the hybrid plan rules.[66]

Open Issues Remain

The final rules do not address many other important aspects of PEP plans, such as whether PEPs are required or even permitted to credit interest to the PEP account following termination of employment. For PEPs that do credit interest after termination of employment, the IRS has noted its concern that the implied interest promise could exceed the normal accrual rate while a participant is still working in violation of the prohibition on benefit reductions on account of increased age or service under Code Section 411(b)(1)(G).[67] The IRS has indicated that it is working to provide guidance on specific PEP issues as a separate project on the recently announced 2014-15 Guidance Priorities List. The IRS also continues to work through determination letter requests that have been pending for many PEPs for more than a decade.

Whipsaw

Section 701 of the PPA provides that a cash balance or other hybrid plan will be able to pay the value of the hypothetical account balance or the accumulated percentage of the participant's final average compensation even if the plan's interest crediting rate is not the 30-year Treasury rate (or its equivalent).[68] This effectively eliminated the "whipsaw" requirement, so that the plan could simply provide that the value of a lump sum distribution is always equal to the participant's account value.[69]

The final regulations generally provide for this rule by indicating that a hybrid plan can provide that the present value of a participant's benefit under a lump sum-based benefit formula is equal to the participant's account as determined under the plan's terms.[70] The final regulations also generally provide that a hybrid plan is permitted to value other optional forms of distribution, including annuities, as the actuarial equivalent, using reasonable actuarial assumptions, of the then-current cash balance account or accumulated benefit.[71]

The elimination of whipsaw was generally effective with respect to distributions made after Aug. 17, 2006. However, Notice 2007-6 indicates that, for an existing plan that provides for the whipsaw calculation, an amendment to eliminate the whipsaw could only become effective at least 30 days after the plan provided notice to participants as may be required under ERISA section 204(h). Also, the cutback relief for an amendment to eliminate whipsaw generally expired at the end of the first plan year beginning in 2009, in accordance with the special cutback relief provided under the PPA. As a result, the ability of a plan that had provided for the whipsaw calculation to permanently eliminate that feature appeared to close at the end of the 2009 plan year.

So, what implications arise for a plan that continues to apply whipsaw? Because whipsaw had been required for some plans pre-PPA, and because the PPA allowed plans to eliminate whipsaw, but did not require its elimination nor add any rules to indicate that whipsaw would be prohibited, many expected that a whipsaw feature, while no longer required, would be permitted post-PPA.

However, surprisingly, the 2014 final regulations made changes that call into question the ability of a plan to continue to provide a whipsaw feature for plan years beginning after 2015. To be eligible for the age discrimination safe harbor rule for cash balance plans, the plan must provide a "lump sum-based benefit formula." The 2014 final regulations modified the definition of this term, for plan years that begin on or after Jan. 1, 2016, to exclude plans that include a whipsaw feature.[72] Under these new rules, a benefit formula will not be a lump sum-based benefit formula unless the single-sum distribution amount under the plan equals the current accumulated participant account balance. A special exception is made for a plan that provides a higher single-sum payment amount in order to satisfy the anti-cutback rules of Code Section 411(d)(6).[73] Thus, it appears that the new regulations would allow a plan with whipsaw to meet the new, tougher standards, by being amended to eliminate whipsaw on benefits accruing after 2015, and permitting the value of the whipsaw feature through 2015 to be included to avoid a violation of the anti-cutback rules.

Vesting

The PPA added new vesting requirements.[74] Benefits under a cash balance or hybrid plan generally must be 100 percent vested after three years of service. This follows the lead in earlier legislation requiring full vesting of matching contributions after three years. Apparently Congress concluded that, if hybrid plans are treated like defined contribution plans for age discrimination purposes, they should also be treated like defined contribution plans for vesting purposes.

Under the final regulations, the determination of whether the three-year vesting rule applies is made on

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[66] Treas. Reg. § 1.411(a)(13)-1(d)(2).

[67] *See* IRS Employee Plan News, Issue 2014-21, December 3, 2014.

[68] ERISA § 203(f) and Code § 411(a)(13).

[69] 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 the participant's normal retirement age benefit. To comply with this rule, the IRS and courts have generally required cash balance plans to project a participant's account balance to normal retirement age and then discount that amount based on the participant's age at distribution using the interest and mortality assumptions applicable under Code Section 417(e). Where a plan's cash balance interest crediting rate exceeds the rate under 417(e) (i.e., 30-year Treasury rates for distributions prior to 2008), this calculation would result in a "whipsaw," causing the minimum present value amount to exceed the participant's account value.

[70] Treas. Reg. § 1.411(a)(13)-1(b).

[71] Treas. Reg. § 1.411(a)(13)-1(b)(3).

[72] Treas. Reg. § 1.411(a)(13)-1(d)(3).

[73] *Id.*

[74] ERISA § 204(f) and Code § 411(a)(13).

a participant-by-participant basis.[75] 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 his or her 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 applies to the entire benefit, even if the non-hybrid formula provides the greater benefit. A traditional pension plan that has 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 (even if the plan does not include a hybrid formula on that date), the vesting change is effective for plan years on and after Jan. 1, 2008. For plans not yet in existence on June 29, 2005, the new vesting rule applies upon the plan commencement. 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).

Conversions

While Congress agreed that cash balance plans were not inherently age discriminatory, they were concerned about how a conversion would impact workers. The PPA provides that any conversion from a traditional pension plan to a cash balance plan occurring on or after June 29, 2005, will not be age discriminatory if a participant's accrued benefit after the amendment is no less than the participant's accrued benefit prior to the conversion (under the terms of the pre-conversion traditional pension plan) for years of service prior to the conversion, plus the participant's accrued benefit under the cash balance or hybrid plan for years of service after the conversion (i.e., an A + B formula).[76] This means that there can be no "wear-away" due to the conversion, and plan participants must continue to accrue benefits after a conversion—just under a different formula. If a participant meets the eligibility requirements to receive an early retirement benefit or retirement-type subsidy under the terms of the traditional pension plan at the time of retirement, the participant must receive such benefit or subsidy under the cash balance or hybrid plan.

General Rule

The statute was designed to prohibit an interaction between the two formulas that results in "wear-away." Wear-away occurs when a participant does not earn additional benefits for some period of time after the conversion because his or her benefit under the new hybrid formula may not initially exceed the benefit earned under the prior formula. To meet this new rule, the plan terms must provide that a participant's benefit will not be less than the sum of (A) the accrued benefit for years of service as determined before the conversion, plus (B) the accrued benefit for years of service completed after the conversion (known as the "A+B" requirement). The final regulations implement this rule and provide additional guidance on its application, including a number of illustrative examples.[77]

Application

The conversion protection rules generally apply when a plan amendment results in the future reduction of traditional pension benefits and, after the amendment, all or a portion of the participant's future benefits are determined under a statutory hybrid benefit formula. A plan is treated as being amended for this purpose if, under plan terms, a change in a participant's employment (*e.g.*, a transfer from a position covered by a traditional formula to a position covered by a hybrid formula) has the same effect as a conversion amendment.

For the A+B calculation, the two portions must be separately calculated as if they were separate plans (*i.e.*, no offsets or other interaction may occur between the two formulas). In addition, 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. Also, the participant's right to receive any early retirement subsidy that had applied 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 separately from the post-conversion account. Under this approach, 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 determined in the same distribution form under the pre-conversion plan terms as of the date of conversion.

Effective Date

Under the statute, the A+B conversion requirement applies to conversion amendments adopted after June 29, 2005. The 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 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 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, these rules would not have to be met. The preamble states that the protections provided under the regulations apply to any participant credited with an hour of service after the regulatory effective date, even if the conversion amendment was before this date (but after the statutory effective date).

[75] Treas. Reg. § 1.411(a)(13)-1(c).
[76] ERISA § 204(b)(5), Code § 411(b)(5), and ADEA § 4(i)(10).
[77] Treas. Reg. § 1.411(b)(5)-1(c).

Consolidation Rules

The regulations provide rules that would treat multiple plan amendments and multiple plans (including plans acquired in a business transaction) as being subject to the conversion rules to the extent the multiple amendments or plans are coordinated in a manner that has the effect of converting a participant's benefit into a new hybrid formula.[78] If multiple amendments are made to one plan and the combined effect is to convert to a hybrid plan formula and the amendments occur within three years of each other, they will be deemed to be subject to the conversion requirements. For example, if the plan is amended to freeze its traditional benefit formula and, within the three following years, the plan is amended to implement a new hybrid formula, the earlier amendment will be treated as a conversion amendment.

Backloading Rules

Once IRS agents started reviewing defined benefit plans that converted from traditional formulas to cash balance formulas in the determination letter process, they began raising the issue of backloading with respect to plans that provide a "greater-of" formula. The purpose of the backloading rules is to prevent a plan's benefit formula from providing greater benefits to longer-service employees (*e.g.,* by providing low benefits in a participant's earlier years of service and higher accruals in the later years), thereby circumventing the vesting rules. The Code requires that a plan satisfy one of three tests designed to ensure that participants earn benefits at a relatively uniform rate throughout their years of plan participation.[79] The IRS was taking the position that the tests for backloading were applied by looking at multiple formulas in the aggregate (as opposed to testing each formula separately) and that under this interpretation a plan that gave participants the greater of the old traditional formula or the new cash balance formula may run afoul of the backloading rules. This raised much consternation in the employee benefit community and the IRS was forced to reexamine its position regarding backloading.

Revenue Ruling 2008-7

On February 1, 2008, IRS issued Notice 2008-7[80] to address this backloading issue. The notice granted relief, stating that plans with greater-of benefit formulas may test each formula on its own to ensure that it passes one of the backloading tests. To be eligible for the relief, a plan must meet one of the following: (1) as of Feb. 19, 2008, the plan provisions describing the greater-of benefit have received a favorable determination letter; (2) as of Feb. 19, 2008, the plan's remedial amendment period for the "greater-of" provisions had not expired; or (3) the plan was on hold in the determination letter moratorium for cash balance plans. The relief was only available for plan years beginning before Jan. 1, 2009. However, the IRS stated that regulations were expected to be issued that would allow separate testing greater-of benefits permanently. These proposed regulations were published on June 18, 2008.[81]

In addition to providing this relief, the notice also goes through the backloading testing analysis of a hypothetical greater-of benefit plan. The analysis is quite detailed and complicated. However, IRS makes a few interesting points in interpreting the rules. First, a plan must pass the backloading tests each year. A plan that passes in one year could fail in a later year, for example, if interest crediting rates are lower or if compensation is higher. Second, a plan may use different tests in different years (the rules already clearly permitted plans to test two groups using different tests, as long as the purpose was not to evade the rules). Note that there is a tension between the backloading rules and the market rate of interest rules described above. Generally, the lower the interest crediting rate, the more difficult it is to pass the backloading tests. However, the plan is forced to use a relatively low crediting rate under IRS's current selection of market rates.

Plans with Variable Interest Rate That May Be Less Than Zero

The final regulations modify the backloading regulations to address a cash balance plan with a variable interest credit that may have a negative return in some years. To show compliance with the backloading rules, such a plan is permitted to assume an interest rate of zero in those years where the actual interest rate is less than zero.[82]

Participant Communication Considerations

Although the courts appear to have settled the issue that cash balance formulas are not inherently discriminatory on the basis of age, other types of claims related to cash balance conversions provide plaintiffs an opportunity to demonstrate harm, and seek damages. Due to the complexity of many conversions, one of those areas is the communication of the changes related to the conversion to a cash balance benefit. In a recent Supreme Court decision, participants claimed they were harmed when a summary plan description arguably promised more benefits than provided under the terms of the plan document.[83] The Supreme Court unanimously ruled that a lower court could not reform CIGNA's cash balance plan to reflect an SPD that arguably promised more benefits.

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[78] Treas. Reg. § 1.411(b)(5)-1(c)(4).

[79] Code § 411(b) describes the 3 percent method, the 133⅓ percent method, or the fractional method as the alternatives for satisfying the backloading requirements.

[80] 2008-7 IRB 419.

[81] 73 Fed. Reg. 34665 (June 18, 2008).

[82] Treas. Reg. § 1.411(b)-1(b)(2)(ii)(G).

[83] *Cigna Corp. v. Amara*, 131 S. Ct. 1866, 50 EBC 2569 (May 16, 2011).

In its opinion, the Court held that the remedy under ERISA to enforce "the terms of the plan" does not provide a remedy for alleged misrepresentation of the terms of a plan in that plan's summary plan description ("SPD"). Provisions of SPDs, the Court determined, are not themselves "terms of the plan" enforceable under ERISA Section 502(a)(1)(B). Opining that relief for the notice violations instead fell within ERISA Section 502(a)(3), which authorizes "other appropriate equitable relief," the Court then went on to enunciate a surprisingly broad interpretation of that phrase—thereby opening the door to claims for relief that many practitioners had assumed had been foreclosed by prior Supreme Court decisions on the scope of relief under Section 502(a)(3).

The Court reasoned that the phrase, "appropriate equitable relief," contemplates categories of relief that were traditionally available in equity courts, and that any of three possible such remedies could be ordered in this case: reformation of contract, estoppel, and monetary compensation against a trustee (known as a "surcharge"). Moreover, essentially of its own volition, the majority entertained an expansive discussion of these various remedies. While it did not require the lower court to apply any particular remedy, the majority provided the lower court with a menu of options that would appear to be viable under Section 502(a)(3).

Turning to the standard of harm required to establish a remediable notice violation, the Court determined that class members must show "actual harm" in the sense that the violation injured individual participants because causation is an element of any possible equitable remedy. However, certain of the possible remedies would not require a plaintiff to demonstrate "detrimental reliance" in order to obtain relief. The standard of harm depends on the kind of equitable relief sought, which the Court found is an analysis for the lower court "to conduct . . . in the first instance" on remand. And, on remand, the district court granted relief to the participant class on the basis of equitable reformation under contract law principles and held that a showing of actual harm was not required, and the Second Circuit affirmed this decision.[84]

The Court's decision presents a mixed bag of rulings on a host of ERISA litigation issues. Plan sponsors will benefit from the Court's ruling that SPDs do not themselves constitute "plan terms," as this holding overrules the opinions of other courts that have found SPDs enforceable as plan documents. The Court's opinion appropriately construes SPDs as summaries not intended to provide or capable of containing all of the provisions described in the plan document itself. On the other hand, the ERISA plaintiffs' bar view *Amara* as a major victory in suggesting the availability of a broad range of equitable relief—including monetary compensation in the form of a surcharge—to individual plan participants as a remedy for notice violations.

Finally, *Amara* should also be viewed along with the Supreme Court's endorsement of an ERISA duty to disclose in *Varity Corp. v. Howe*.[85] Given the complexity of communications regarding cash balance conversions, and the explanation of benefits for cash balance plans, one can certainly imagine that plaintiffs' attorneys will be looking for discrepancies between plan terms and participant communications, and will be able to find them. With the *Amara* decision, it becomes even more important to carefully examine the SPDs and other participant communications for consistency with plan terms.

Conclusion

For current sponsors of cash balance plans and for employers considering a move to cash balance formulas, court decisions and the recent 2014 final and proposed regulations provide considerable comfort and encouragement, though not entirely without pitfalls and risks in certain areas. Perhaps more importantly, these continuing developments provide good news to participants and participant advocates who mourn the decline of defined benefit pension plans in the marketplace. Generally, cash balance plans should be a viable alternative for sponsors who do not want to push retirement investment risks solely onto participants, but also do not want to continue providing benefits under traditional defined benefit formulas. Additionally, with the final regulations permitting several new interest crediting options, there is a new range of investment risk management opportunity for cash balance plans that did not exist under traditional defined benefit formulas.

[Updated March 2015]

[84] *Amara v. CIGNA Corp.*, 775 F.3d 510, 2014 BL 361081 (2d Cir. 2014).

[85] 516 U.S. 489, 19 EBC 2761 (1996).