

January 5, 2007

MEMORANDUM TO CLIENTS

RE: **Cash Balance Plans – End of Determination Letter Moratorium and Initial IRS Guidance for PPA Changes**

In Notice 2007-6 (Jan. 16 IRS Bulletin), the IRS announced that it is beginning to process determination letter applications for cash balance plans that have been subject to an IRS moratorium for many years. The Notice also provides some initial transition guidance and solicits comments regarding the new rules applicable to cash balance and other hybrid pension plans enacted as part of the Pension Protection Act of 2006 ("PPA").

A. **Determination Letter Process**

Determination letter applications for defined benefit plans that had been converted to cash balance and other hybrid designs (generally referred to as "hybrid plans" in this article) have been held up in a moratorium for over 7 years – since September 15, 1999. The moratorium had been imposed in light of mounting questions (including in numerous class action lawsuits) about the legality of hybrid plans and possible regulatory or legislative action to address the issues. In light of the legislative validation of hybrid plans under the PPA, the IRS has lifted the determination letter moratorium. For purposes of processing these determination letter requests, the IRS provides the following guidance:

- **Age Discrimination.** In general, the IRS will review plans to determine if accruals for periods after the conversion satisfy the age discrimination accrual rules in Code section 411(b)(1)(H). For this purpose, a plan will not be considered age discriminatory merely because it provides that interest credits through normal retirement age are accrued in the year of the related hypothetical allocation. However, the IRS will not consider whether any pre-June 30, 2005 conversion, including any wear-away period that followed the conversion, satisfied the age discrimination rules. Thus, it appears the IRS is taking the position that the basic cash balance benefit formula is not age discriminatory – the issue that continues to vex the courts – but that it will not opine as to whether the effect of the conversion of the prior traditional benefit to a cash balance benefit satisfies age discrimination rules.

We note that class action cases regarding whether pre-PPA cash balance accruals satisfy age discrimination requirements continue to rage on, with courts coming out on both sides of the issue. While courts have not typically given much evidentiary weight to IRS determination letters, the guidance in Notice 2007-6 that the "frontloading" of interest credits will not be viewed by the IRS as age

discriminatory may be helpful in the defense of plan sponsors that are subject to these suits.

- **Pre-PPA Distributions.** The Notice indicates that the IRS will issue guidance interpreting the PPA effective date rules for relief from the Code section 417(e) requirements for valuing lump-sum distributions. Until that guidance is issued, the IRS will not issue a determination letter for a plan that does not satisfy the requirements of Notice 96-8 (which generally requires the so-called 417(e) "whipsaw" calculation for plans that do not use one of the interest rates approved in 96-8) for distributions made before August 18, 2006.
- **Backloading.** The Notice notes that the backloading rules under Code section 411(b)(1)(A), (B) and (C) were not modified by the PPA and continue to apply. As with pre-moratorium determination letter reviews, we expect the IRS to look closely at whether and how hybrid formulas satisfy the backloading rules.
- **Terminating Plans.** The IRS notes that the PBGC has indicated that the PPA's relief from the 417(e) rules will not apply to any plan that has a termination date prior to August 18, 2006. This appears to mean that a plan that had been required to apply the 417(e) "whipsaw" rules as stated in Notice 96-8, must continue to apply those rules to all distributions if it is terminated effective as of any date prior to August 18, 2006.
- **Post-6/29/05 Conversions.** If a plan was converted to a hybrid design by an amendment adopted after June 29, 2005, the IRS will review the conversion to determine if it complied with the conversion requirements of the PPA.

B. Transition Guidance

The Notice provides initial transition guidance on the application of some of the new hybrid plan rules enacted as part of the PPA.

Definition of "Statutory Hybrid Plan" – The PPA provides special rules that allow cash balance plans and other hybrid pension plans to automatically satisfy the age discrimination rules and to avoid application of the whipsaw effect that can be caused by application of the lump-sum valuation rules under Code section 417(e) (as interpreted by the IRS in Notice 96-8). A cash balance or other hybrid plan can take advantage of these new rules if they meet the PPA's definition of an "applicable defined benefit plan." These plans generally include any defined benefit plan under which the accrued benefit is calculated as a balance of a hypothetical account or as an accumulated percentage of final average compensation. The Notice generally describes these plans as "statutory hybrid plans." Importantly, the Notice expands on the PPA definition to include a plan "under which the accrued benefit under the terms of the plan is calculated as the actuarial equivalent of such a hypothetical account balance or accumulated percentage." Consistent with prior law, many existing hybrid plans include a definition of accrued benefit that converts the plan's present value benefit to a normal retirement age annuity. There was some concern that such plans may not be eligible for the new PPA rules unless their form was changed

to eliminate the normal retirement age annuity reference. It appears that the IRS does not view the new law as elevating form over substance in this manner.

The PPA instructs the Treasury to issue regulations to include plans that have an effect similar to an applicable defined benefit plan. The Notice indicates that plans that provide that a participant's normal retirement age benefit is expressed as a benefit that includes automatic periodic increases through normal retirement age, such as an indexed annuity plan, will be considered statutory hybrid plans. The Notice provides that plans that solely provide for post-normal retirement age indexing will not be considered statutory hybrid plans. Also, a variable annuity plan will not qualify if it has an assumed interest rate of 5% or more; the Notice describes a variable annuity plan for this purpose as any plan which provides that the amount payable is periodically adjusted by reference to the difference between the rate of return of plan assets or specified market indices and the assumed interest rate.

Relief From the 417(e) Lump-Sum Valuation Rules – The PPA generally permits qualifying hybrid plans to provide lump-sum benefit payments equal to the balance of the participant's hypothetical account (in the case of a cash balance plan) or the accumulated percentage of final average pay (in the case of a pension equity plan) without application of the 417(e) lump-sum valuation rules. The Notice provides the following guidance on the implementation of this rule:

- **Relief Limited to Certain Hybrid Plans.** Relief from the 417(e) rules applies only to plans where the benefit is based on a hypothetical account or the accumulated percentage of final average pay. It does not extend to other statutory hybrid plans (such as certain indexed benefit plans) that are eligible for the age discrimination relief and other hybrid plan rules of the PPA.
- **Effective Date Guidance Forthcoming.** The PPA provides that relief from the 417(e) rules is effective for distributions made after August 17, 2006. The Notice indicates that the IRS expects to issue regulations "shortly" interpreting this effective date. It appears that the guidance will be targeted to how the law change could impact distributions made prior to August 18, 2006. As noted above, the IRS will not issue determination letters for plans that did not follow the rules in 96-8 in making distributions prior to August 18, 2006 until further guidance is issued.

Cut-Back Relief and Required Notice For Plans That Eliminate Whipsaw – Some existing hybrid plans contain provisions for the whipsaw calculation described in Notice 96-8. This is most common in cash balance plans that provide interest credits at a minimum fixed rate that has exceeded the rate on 30-year Treasury securities applicable under the 417(e) rules. For example, where a plan has a minimum crediting rate of 5.5% and the applicable rate under 417(e) is less than 5.5%, the whipsaw calculation will cause the lump-sum distribution to exceed the participant's account balance. The PPA's effective date and cut-back rules generally provide broad relief for such plans to eliminate the whipsaw calculation for distributions after August 17, 2006. The Notice confirms the IRS view that the PPA permits a plan to be amended to eliminate the whipsaw calculation. However, the Notice provides that such an amendment would generally be subject to the advance participant notice requirements under ERISA section 204(h)

and Code section 4980F. The Notice provides that the elimination of whipsaw may occur only if a 204(h) notice is provided at least 30 days prior to the effective date of the elimination. The actual amendment will not need to be adopted until the end of the first plan year beginning on or after January 1, 2009.

Market Rate of Return –The PPA requires that interest credits to cash balance accounts may not be made at a rate that exceeds a "market rate of return." The Notice indicates that Treasury intends to issue guidance in 2007 that addresses this requirement, including special rules on what minimum rates of return should be permitted, how the preservation of principal rule should be applied (the PPA provides that an interest credit of less than zero may not cause a participant's account balance to be less than the aggregate contributions credited to the account), and the extent of any relief from the anti-cutback rules of Code section 411(d)(6) for a plan amendment that changes the plan's cash balance interest crediting rate provisions. Pending further guidance, the Notice provides that a market rate of return will include (1) the rate of return on long-term investment grade corporate bonds, (2) the rate of interest on 30-year Treasury securities (as provided in Code section 417(e) before amendment by the PPA), and (3) the sum of any of the standard indices and associated margin for that index described in Notice 96-8.

Special Rules For Conversion Amendments – The PPA provides several requirements for the conversion of an existing defined benefit plan from a traditional benefit formula to a hybrid plan formula under an amendment adopted after June 29, 2005. The Notice largely restates the PPA's requirements in this regard, which generally require a participant's final benefit to equal the sum of (A) the accrued benefit accrued prior to the conversion, plus (B) the benefit accumulated under the new hybrid benefit formula from the date of conversion forward. A special rule in the PPA also requires that any early retirement and retirement-type subsidies under the plan's prior benefit formula that the participant is qualified to receive in the year of retirement must be credited to the participant's hybrid plan account. The Notice clarifies that the retirement subsidy determination is made as of the benefit commencement date for the participant.

Mergers and Acquisitions – As required by the PPA, the IRS indicates that it expects to issue regulations by August 17, 2007, regarding an amendment that converts a defined benefit plan into a hybrid plan with respect to a group of employees who become employees by reason of a merger, acquisition or similar transaction. Pending further guidance, the Notice indicates that such an amendment will not cause a violation of the age discrimination rules if the benefit for the affected participants is at least equal to the sum of (A) the benefits and rights earned under the old plan and protected by the cut-back restrictions of Code section 411(d)(6) as of the date of conversion (which could include early-retirement and retirement-type subsidies provided under the old plan), plus (B) the 411(d)(6) protected benefits earned under the hybrid plan provisions from the date of conversion forward.

C. Request for Comments

The IRS expects to issue proposed regulations with respect to this initial transitional guidance. They note that the initial regulations will not address all outstanding issues relating to

the PPA rules for hybrid plans. In advance of the issuance of the proposed regulations, the IRS has asked for comments (by April 16, 2007) on the following issues:

- **Market Rate of Return.** The IRS requests input on the appropriate definition of a "market rate of return," including what minimum rates of return should be permitted, how the preservation of principal rule should be applied, and the extent of any relief from the anti-cutback rules of Code section 411(d)(6) for a plan amendment that changes the plan's cash balance interest-crediting rate rules.
- **Partial Hybrid Plan Benefits.** Comments are requested on how the PPA's hybrid plan rules should be applied to plans where only some participants' benefits, or only a portion of certain participants' benefits, are determined with reference to a hybrid benefit formula, including plans that involve an offset for benefits under another plan.
- **Multiple Amendments.** The PPA requires the Treasury to issue regulations to prevent the avoidance of the purposes of the hybrid plan rules through the use of two or more plan amendments, rather than a single amendment. The IRS requests comments on how the use of multiple amendment or multiple plans can have the effect of a conversion of a plan to a hybrid plan.
- **Pension Equity Plans.** The IRS requests input on how other qualification rules, other than the age discrimination and lump-sum valuation rules, apply to hybrid plans where the benefit is calculated as an accumulated percentage of the participant's final average compensation. This type of design is typically referred to as a "pension equity plan" or "PEP." In this regard, the IRS specifically invites comments on how (or whether) these plans should credit interest with respect to terminated vested participants.
- **Benefit Indexing.** The PPA permits hybrid plans to include certain arrangements where benefits increase under a specified index. The IRS requests comments on the appropriate type of indexing that should be permitted and whether there are any types of indexed plans that should not be treated as hybrid plans.

D. Future Prospects

Between the processing of determination letters for hybrid plans, further guidance regarding the new PPA rules, and rulings in the many pending cash balance class action cases, 2007 will be a busy year for hybrid plan issues. Developments in all these areas will be relevant to employers who currently sponsor hybrid plans, as well as to employers who are, or may be, considering a conversion to a hybrid plan in the future.