

## IBM Court and Congress Weigh in on Hybrid Plans

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Thanks to recent actions in Congress and the courts, the past and future outlook for hybrid plans is brighter. First, Congress addressed the plans in its massive pension reform bill—the Pension Protection Act of 2006 (PPA)—which was passed on August 3, 2006. Then, on August 7, the United States Court of Appeals for the Seventh Circuit rejected claims that IBM’s cash balance plan violated the age discrimination provisions of ERISA. The decision in *Cooper v. IBM Personal Pension Plan* applies to periods before the effective date of the PPA. Yesterday, President Bush signed the new legislation, which is generally effective for periods beginning on and after June 29, 2005, though some rules will not apply until the first plan year beginning after December 31, 2007.

### ***Cooper v. IBM*—Cash Balance Plans Did Not Violate Age Discrimination Rules of Old Law**

The IBM plan followed the typical cash balance plan design (one of the designs also known as hybrids) of creating phantom or hypothetical individual accounts for participating employees. Each employee received two types of credits to his or her hypothetical account each month—a pay credit and an interest credit. The pay credit was five percent of the employee’s gross taxable income, and the interest credit was set at 100 basis points above the one-year Treasury Bill rate. The IBM plan thus looked much like a defined contribution plan, but in fact was a defined benefit plan. The plan promised each employee the full amount “held” in his or her hypothetical account, regardless of any actual losses in plan assets. The benefit could be taken as a lump sum or converted to an annuity. A participant who terminated employment, but deferred taking his or her benefit, continued to have interest credited to his or her account, but did not accumulate additional pay credits.

A class of employees sued the plan and IBM, claiming that the plan design violated section 204(b) of ERISA. That section sets out specific prohibitions designed to combat age discrimination in defined benefit and defined contribution plans. A defined benefit plan is not permitted to cease or reduce the rate of an employee’s “benefit accrual” because of age. A defined contribution plan is not permitted to cease allocations to an employee’s account or reduce the rate of allocations because of age.

Even though the IBM plan would not have been discriminatory if it had been a true defined contribution plan, because contributions to each hypothetical account did not vary because of age, the employees claimed that the plan could not satisfy ERISA’s requirements as a defined benefit plan. The employees asserted that the prohibition against age-based differences in benefit accrual was a reference to a participant’s “accrued benefit,” which is a defined term under ERISA. For defined benefit plans,

the accrued benefit must be expressed in the form of an annual benefit commencing at normal retirement age. By contrast, the accrued benefit in a defined contribution or individual account plan is the balance in the participant's account.

Writing for a three-judge panel, Judge Easterbrook concluded that the phrase "benefit accrual" is not the same as "accrued benefit." The court recognized that someone who leaves IBM at age 50, after 20 years of service, will have a larger annual benefit at 65 than someone whose 20 years of service concludes with retirement at age 65, and thus will have a higher "accrued benefit." The younger employee receives 15 more years of interest than the older worker, which then produces a higher amount when "expressed in the form of an annual benefit commencing at normal retirement age." The court said that looking at the benefit in this way treats the time value of money as age discrimination, but concluded that because the role of interest is not treated as age discrimination in a defined contribution plan, it should not be considered discrimination in a defined benefit plan. Noting that the age discrimination provisions for defined benefit and defined contribution plans "are so close in both function and expression," the court ruled that benefit accrual for a defined benefit plan is the same as for a defined contribution plan—it refers to what the employer puts in or imputes to a plan participant's hypothetical account, not what the participant takes out at retirement.

The court emphasized that the IBM plan is age neutral on its face, because there is no age-based difference in the amounts imputed to an older employee's and a younger employee's hypothetical accounts. Pointing out that it is "essential to separate *age discrimination* from other characteristics that may be correlated with age," Judge Easterbrook noted that the differences in pension benefits in IBM's plan "are a function of differing years of service, salary history, or the years the balance has been allowed to compound," and not age. Finally, the court pointed out that under proposed regulations from the Treasury Department that were later withdrawn, the "rate of benefit accrual" for a cash balance plan would be "the additions to the participant's hypothetical account for the plan year," supporting the court's own reading of the law.

### **Pension Protection Act Validates Hybrid Plans After June 2005**

The PPA codifies the view that hybrid plans, including cash balance plans do not discriminate on the basis of age, as long as the accrued benefit of one participant is equal to or greater than the accrued benefit of any similarly situated younger participant. The significant change here is that the accrued benefit may be expressed as an annuity payable at normal retirement age (as under current law), **or** as the balance of a hypothetical account, **or** as the current value of the accumulated percentage of the employee's final average compensation. Thus, a cash balance plan is free to determine a participant's accrued benefit by looking at the balance in his or her hypothetical account, as long as the plan defines the accrued benefit in that form. Where the plan is age neutral—that is, where the employer imputes the same pay credits and interest credits to participant accounts without regard to age—the plan will satisfy ERISA's age discrimination rules.

A participant is similarly situated to another participant if he or she is identical to the other individual in every respect other than age, including period of service, compensation, position, date of hire, work history, and any other respect. In determining the accrued benefit, the subsidized portion of any early retirement benefit or retirement-type subsidy is disregarded.

Other features of the new law are as follows:

- **Three-Year Vesting:** A cash balance or other hybrid plan participant must be fully vested in his or her hypothetical account in no more than three years.
- **Interest Credits:** The interest credit for any year must be at a rate that is not greater than the market rate of return, although a plan may provide for a reasonable minimum guaranteed rate that is equal to a fixed or variable rate of return, whichever is higher.
- **Conversion to Cash Balance or Other Hybrid Plan:** If a defined benefit plan is converted to a cash balance or other hybrid plan, the plan must provide that the accrued benefit of an individual who was a participant immediately before the conversion is not less than the sum of (1) the participant's accrued benefit for years of service before the effective date of the conversion, determined under the terms of the plan as in effect before the conversion; and (2) the participant's accrued benefit for years of service after the effective date of the conversion, determined under the terms of the plan as in effect after the conversion. If the plan provides a subsidized early retirement benefit prior to conversion, and a participant satisfies the preconversion requirements for the benefit at termination of employment, the participant's hypothetical account must be credited with an additional amount equal to the value of the early retirement subsidy based on the participant's preconversion accrued benefit.
- **Termination of Cash Balance Plan:** Upon termination, if the interest credit rate under a cash balance plan is a variable rate, the rate used to determine accrued benefits under the plan must be equal to the average of the rates of interest used during the five-year period preceding the plan's termination. In addition, the interest rate and mortality table used to determine the amount of any benefit expressed in the form of an annuity payable at normal retirement age must be the rate and table specified under the plan for such purposes as of the termination date.
- **No Inference to Be Drawn from New Law:** The PPA expressly states that in construing the new statute, no inference is to be drawn regarding the legality of cash balance and other hybrid plans under ERISA's age discrimination provisions for any period prior to the effective date of the new law. Thus, litigation with respect to pre-effective date periods is not precluded.
- **Effective Dates:** In general, the new rules are effective for periods beginning on or after June 29, 2005. For plans in effect on June 29, 2005, the interest credit and vesting requirements generally apply to years beginning after December 31, 2007, except that the plan sponsor may elect to have them apply for any period after June 29, 2005 and before the first plan year beginning after December 31, 2007. A delayed effective date applies to collectively bargained plans.

The minimum value rules (permitting the accrued benefit to be expressed as the balance in a hypothetical account or as an accumulated percentage of final average compensation) are effective for distributions after the date of enactment. This means that the new statutory safe harbor applies to preenactment benefit accruals.

The provisions relating to plan conversions apply to plan amendments adopted after (and taking effect after) June 29, 2005, except that a plan sponsor may elect to have them apply to amendments adopted before and taking effect after that date.

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