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Final and Proposed Regulations on Hybrid Pension Plans

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On October 19, the Internal Revenue Service (IRS) published final and proposed regulations for hybrid pension plans, which include cash balance and pension equity plans. These regulations provide guidance on changes made by the Pension Protection Act of 2006 (PPA) and the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA).

The final regulations generally adopt the transitional guidance provided in IRS Notice 2007-6 and in proposed regulations published in December 2007, with certain modifications. The proposed regulations address other issues, most notably details on the market rate of return rules, that were not addressed in the final regulations. Highlights of the final and proposed regulations follow.

Final Regulations

Definitions. The final regulations define a statutory hybrid plan as a defined benefit plan with a benefit formula that is either a lump-sum-based benefit formula or a formula that has a similar effect. This definition will generally apply to cash balance plans, which provide that the accumulated benefit is expressed as the current balance of a hypothetical account, and to pension equity plans, which provide that the accumulated benefit is the current value of an accumulated percentage of a participant's final average compensation. The final regulations provide that a lump-sum-based formula that credits interest must satisfy the market rate of return rules, which are discussed in more detail below. A participant's accumulated benefit is a participant's benefit accrued as of any date under a plan. A benefit is expressed as a hypothetical account if it is expressed as a current single-sum dollar amount, whether or not the participant has the right to future interest credits.

Pension Equity Plans. Some pension equity plan (PEP) formulas provide for interest credits after accruals cease (e.g., following termination of employment). The final regulations state that if a PEP formula provides for interest credits, the market rate of return rules will apply. The IRS and Treasury requested comments on the rules that should apply to a PEP formula if no interest is credited after accruals cease. An example in the final regulations and an express provision in the proposed regulations suggest, however, that unless a cash balance or PEP formula credits interest to deferred vested former employees, it will not qualify for PPA relief from age discrimination prohibitions.

Internal Revenue Code (Code) Section 411(a)(13)(A) Requirements. The PPA added this Code provision to ensure that a statutory hybrid formula that met specified requirements would meet other applicable Code requirements and satisfy age discrimination concerns when the present value of benefits, as determined under a lump-sum-based benefit formula, equals the then-current balance of the participant's hypothetical account. To satisfy the age discrimination safe harbor, a participant's accumulated benefit cannot be less than any younger, similarly situated participant's accumulated benefit expressed under the same formula. For example, a cash balance formula that credits a participant annually with 5% of pay and a specified fixed or variable interest rate would fail to satisfy this requirement if any older, similarly situated participant was credited with a lower percentage of pay or a lower rate of annual interest. The proposed regulations include additional conditions (discussed below) to satisfy the age discrimination safe harbor.

Vesting. The final regulations confirm that the three-year 100% vesting requirement for a statutory hybrid benefit applies to the participant's entire benefit under the plan, even if a portion of the benefit is not determined under a statutory hybrid benefit formula.

Conversion Protection. The final regulations specify the rules that must be met when a traditional defined benefit plan is converted to a statutory hybrid benefit plan. In general, as a minimum, a participant must be given a benefit after the conversion that is at least equal to the sum of (i) the benefits accrued prior to the conversion and (ii) the benefits accrued after the conversion, with no permitted interaction between the two portions.

Interest Credits and Market Rate of Return. Interest credits are credits (or debits) to a participant's account not conditioned on current service and not made because of imputed service. The IRS previously published a list of permissible safe harbor interest rates, and also specified yield curves (in three segments) for making funding assumptions and determining the present value of lump sums. The final regulations expand the list of safe harbor interest rates to include the first and second segment rates as well as third segment rates. Under certain conditions, a plan can use the actual rate of return on the aggregate assets of a plan or the rate of return on an insured annuity contract as a safe harbor rate. Some statutory hybrid plans use more than one interest rate in determining adjustments to a participant's account. The final regulations permit a plan to use a particular crediting rate that is always less than a safe harbor rate, or that is always equal to the lesser of two or more rates when at least one of the rates is a safe harbor rate. The right to future interest credits that are not conditioned on future service is specifically identified as a protected benefit under Code section 411(d)(6).

The final regulations also specify what constitutes a permissible stability period (the period during which an interest rate is in effect) and lookback month(s) (the month or months used to determine the applicable interest rate). To meet market rate of return safe harbors, a statutory hybrid plan must use a lookback month and stability period that are permissible under Code section 417(e), but the stability period and lookback month need not be the same as those used under the plan for purposes of section 417(e). Because the market rate of return requirements are not generally effective until the proposed regulations become effective, any amendment to change the lookback month and stability period for purposes of determining interest credits under a statutory hybrid plan would not generally be required prior to January 1, 2012.

Effective Date. The final regulations are generally effective January 1, 2011.

Proposed Regulations

Optional Forms of Benefit. It was unclear whether optional forms of benefit payable prior to normal retirement under a statutory hybrid plan could be determined based on the accumulated benefit, or if they had to be determined as the actuarial equivalent of the accrued benefit payable at normal retirement. The proposed regulations state that the relief under Code section 411(a)(13) extends to calculations of optional forms of benefits as well as lump-sum distributions. As a result, the actuarial equivalent (determined using reasonable actuarial assumptions) of the then-current balance of the hypothetical account or other accumulated benefit can be used to determine benefits as of an annuity starting date prior to normal retirement. The relief will also apply on a proportionate basis in the event of a partial distribution of a participant's benefit. Specifying actuarial equivalence in the plan document by reference to the accumulated benefit will simplify plan administration and ease compliance with relative value disclosure.

Further Conditions for Age Discrimination Safe Harbor. The proposed regulations provide that after a participant reaches normal retirement age, unless the statutory hybrid benefit plan meets the suspension of benefit rules, the value of the participant's benefit must be increased by at least the value of an actuarial increase that reflects both the delay in payment and the participant's increased age. Some hybrid plans that did not meet the suspension of benefit rules simply credited interest on the participant's hypothetical account at the plan's usual rate. If the final regulations retain this requirement, those plans would need to be amended to ensure that the actuarial adjustment is a floor increase. Separately, the proposed regulations provide that the interest crediting rate will not be treated as exceeding a market rate of return merely because, as of each annuity starting date after normal retirement, the benefit is equal to the greater of the benefit determined using the plan's usual interest crediting rate or a benefit that satisfies the requirements of Code section 411(a)(2), relating to actuarial increases.

Market Rate of Return. The proposed regulations broaden the list of safe harbor interest-crediting rates. They permit use of a fixed annual floor of 4% interest with a permissible bond rate. A fixed annual rate of 5% is a safe harbor rate, but it could not generally be coupled with another rate. A 3% floor that applies cumulatively may be combined with any permissible rate. The actual rate of return on plan assets is allowed to be used as a market rate of return if plan investments meet specified diversification requirements.

Many statutory hybrid plans credit interest under a "better of" formula or with a floor rate of interest that would not meet the market rate of return requirements. These plans would need to amend their interest-crediting rates prior to the effective date of the new rules. In addition, if a minimum interest rate in excess of an allowable rate was adopted to enable the plan to satisfy benefit accrual rules (e.g., under a service-weighted formula), the formula for principal credits would need to be revised. The proposed regulations do not address in detail how a reduction in the plan's interest rate to meet the market rate of return rules would interact with Code section 411(d)(6) requirements or whether a Code section 204(h) notice would be required. The preamble to the proposed regulations states that section 411(d)(6) relief can be expected, provided the amendment is timely adopted and "the elimination or reduction is made *only to the extent necessary* to enable the plan to meet" applicable requirements (emphasis added). Comments have been requested as to how the "only to the extent necessary" standard should be applied. Plan sponsors will generally want to postpone amendments to bring the plan into compliance with the market rate of return requirements until further guidance is issued on the extent of the section 411(d)(6) relief.

Plan Terminations. The proposed regulations provide detail on the Code requirement for using a five-year average for the applicable interest rate to determine a participant's accumulated benefit in the event of plan termination. This requirement only applies if the interest crediting rate to determine a participant's accumulated benefit or annuity is variable. The average rate would be used to credit interest after plan termination or to compute annuities payable after normal retirement age.

Effective Date. The proposed regulations, when finalized, will not take effect before January 1, 2012. Because of the complexity of the open issues relating to the market rate of return requirements and the burden of other regulatory projects, delay beyond that date is not unlikely.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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