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Legal Alert:
Pension Protection Act of 2006 – Congress Clears the Way for Cash Balance and Other Non-traditional Defined Benefit Plans

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Defined benefit pension plans were once the cornerstone of the private retirement income system. For several reasons, however, the prevalence of these plans has declined dramatically over the past couple of decades. Cash balance plans, pension equity plans and other "hybrid plans" were developed in an effort to revitalize the retirement plan that promised a benefit amount to participants, rather than basing a significant portion of retirement income on the investment performance of plan assets. As these hybrid plans gained acceptance with plan sponsors, however, the arrangements increasingly became the subject of controversy in the media, government agencies, Congress and the courts, particularly with respect to the conversion of traditional defined benefit plans to one of the hybrid plan designs. This controversy stymied the use of hybrid plans.

By legislatively resolving the key issues that have arisen in litigation and under previously proposed (and subsequently withdrawn) Treasury regulations – particularly those concerning age discrimination and the methodology for calculating lump sum distributions – Congress has greatly facilitated the prospective implementation of cash balance plans and other hybrid plans. The Pension Protection Act of 2006 amends ERISA, the Internal Revenue Code (the "Code") and the Age Discrimination in Employment Act ("ADEA") to provide that a hybrid plan will not violate ERISA, fail to qualify for tax-exempt status under the Code, or discriminate on the basis of age if certain requirements are satisfied. The following is a discussion of the background that led to the adoption of these new rules, as well as the requirements of these rules.

Background

Decline of Traditional Defined Benefit Plans. According to the Department of Labor Bureau of Labor Statistics, in 1985, 80% of full-time employees of private employers with 100 or more employees was covered by a defined benefit plan. By 2000, however, this type of plan covered only 36% of these employees.

Several reasons explain the decline in popularity of defined benefit plans. Legal issues were a major factor. Tax laws were changed to limit significantly an employer's ability to recover surplus assets from overfunded plans, and the minimum funding requirements applicable

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to these plans were tightened. Economic issues were also significant. As investment performance declined and interest rates dropped, plans became inadequately funded and expensive to maintain. In addition, the increasingly transient nature of the American labor market made these plans less meaningful to employees. Traditional defined benefit plans do not provide "portable" benefits and require long service to maximize the value of the benefit; as a result, younger employees often do not find them valuable.

Hybrid Plans. Hybrid plans address many of these issues. Cash balance plans typically provide a benefit equal to the aggregate amount of employer contributions and "interest credits" made on behalf of an employee. While such an arrangement looks a lot like a typical defined contribution plan, the cash balance plan often calls for interest credits to be made at a set rate, thereby protecting participants from investment risk and effectively promising a benefit amount at benefit commencement. Pension equity plans usually provide a participant with a lump sum benefit equal to a specified percentage of his or her final pay. Pension equity plans look more like typical defined benefit plans than do cash balance plans, but the value of the benefit is not dependent on life expectancies and interest rates. These arrangements give employers more control over costs, provide benefits that can be paid out at termination of employment (rather than retirement age) and rolled over to IRAs or other qualified plans, and are often better appreciated by younger workers.

Age Discrimination Concerns. These arrangements have not, however, been viewed favorably by older workers, many of whom participate in plans that were "converted" from a traditional defined benefit arrangement to a hybrid arrangement. As a result, age discrimination lawsuits were brought against employers who maintained these arrangements. There were two theories on which arguments that hybrid plans discriminated against older workers were based. First, the cash balance structure itself was seen as providing a greater benefit to a younger employee than to a similarly situated older employee, because the amount credited to the younger employee's account for any year would earn more interest credits (because they would be received for more years) than the amount credited to the older employee's account for the same year. Second, in some conversions from traditional defined benefit plans to hybrid plans, employees were promised a benefit equal to the greater of the present value of their benefit accrued under the traditional defined benefit formula and the benefit they would have earned if the hybrid formula had been in place for all their years of service. In the case of many older employees, the lump sum value of the traditional defined benefit was greater than the hybrid-formula benefit, and would continue to be so for several years; as a result, under a plan incorporating a "wearaway" provision of this type, such a participant would not accrue additional retirement benefits in years in which similarly situated younger workers were accruing benefits under the new plan formula.

The courts have been divided in their decisions about whether these features of hybrid plans are age discriminatory. In addition, in 2002, the Internal Revenue Service proposed

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regulations under which many hybrid plans would be considered age discriminatory. Although these proposed regulations were withdrawn fairly quickly, employers remained concerned because some members of Congress were vocal in labeling cash balance and other hybrid plans as age discriminatory.

Whipsaw Effect. An additional controversy arose in connection with cash balance plans. Participants brought lawsuits challenging the manner in which their lump sum benefits were calculated under the plans. Employers intended the plans to pay only the aggregated amount of contributions and interest credits allocated to a participant's account. Participants, however, claimed that the Code and related regulations required the plan to project interest credits to their normal retirement date and then discount that amount back to the date of payment. If the rate at which a plan provided interest credits was higher than the rate required for valuing lump sums under the Code, the participant would be entitled to an amount greater than the participant's cash balance account. (The result of this calculation methodology came to be referred to as the "whipsaw effect.") Again, courts have been divided in their interpretations of existing law in these suits.

Current Status. To add to the confusion, the IRS stopped issuing determination letters on hybrid plans that were converted from traditional defined benefit plans and, to this date, refuses to issue them. As a result of all of these factors, the use of hybrid plans, though frequently attractive to employers from several perspectives, has been hampered. Under the provisions of the Act, however, employers can have confidence that, if certain requirements are satisfied, the implementation of new hybrid plans, and the prospective conversion of traditional defined benefit plans, will not subject them to age discrimination claims or to the "whipsaw effect."

The New Rules

As noted above, the Act amends the Code, ERISA and ADEA to address the issues raised by hybrid plans. Because the modifications to these three statutes are virtually identical, for the sake of clarity, the following discussion will refer only to the new provisions of the Code.

The amendments made by the Act apply to section 411(b), which sets forth rules relating to the accrual of benefits under qualified plans, and section 411(a), which establishes the vesting requirements applicable to these plans. Section 411(b)(1)(H) requires that a plan not cease or reduce benefit accruals on account of a participant's age. The Act adds new section 411(b)(5), which provides that an "applicable defined benefit plan" will not fail to satisfy section 411(b)(1)(H) if certain requirements are satisfied. For this purpose, an "applicable defined benefit plan" is defined in new section 411(a)(13) as "a defined benefit plan under which the accrued benefit (or any portion thereof) is calculated as the balance credited to a hypothetical

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account maintained for the participant or as an accumulated percentage of the participant's final average compensation."

Accrued Benefit Not Dependent on Age. The principal requirement of section 411(b)(5) is that, as of any date, a participant's accrued benefit under the plan must be at least as great as that of any similarly situated younger individual who is or could be a participant in the plan. Individuals will be considered "similarly situated" if they are identical in every respect (including period of service, compensation, position, date of hire and work history) ***except*** age. For this purpose, though, the subsidized portion of any early retirement benefit or retirement-type subsidy is disregarded.

Interest Crediting Rate. Because younger workers are generally entitled to more interest credits on a current year's allocation than are older workers, to balance concerns about age discrimination and to prevent employers from disguising excessively generous benefits to younger workers as "interest credits," new section 411(b)(5)(B) provides that a plan will fail to satisfy the requirements of section 411(b)(1)(H) unless the terms of the plan provide that any interest credit (or equivalent amount) for any plan year will not be at a rate greater than a market rate of return. However, a plan can provide for a reasonable minimum guaranteed rate of return or credit interest at the greater of a fixed or variable rate. The Act does not provide a definition of "market rate of return" or "reasonable minimum guaranteed rate of return," but authorizes Treasury to clarify these terms in the regulations. Notwithstanding the requirement generally limiting interest credits to market rates, section 411(b)(5)(B)(i)(II) provides that the use of interest credits of less than zero cannot cause a participant's benefit at any date to be less than the aggregate amount of contributions credited to the participant's account as of that date. Section 411(b)(5)(B)(vi) sets forth special rules relating to the interest rates and other assumptions to be used in calculating benefits upon plan termination.

Accelerated Vesting. New section 411(a)(13)(B) imposes a more stringent vesting requirement on hybrid plans. Specifically, an applicable defined benefit plan must provide for 100% vesting for all participants with at least three years of service.

Conversions. In addition to these requirements that apply to all applicable defined benefit plans, section 411(b)(5)(B) also includes rules governing conversions of traditional defined benefit plans. Specifically, in the case of an applicable defined benefit plan that results from the conversion of a traditional defined benefit plan, a participant's accrued benefit under the plan must at all times equal the sum of (1) the participant's accrued benefit for years of service before the date of the conversion, determined under the terms of the plan as in effect before the conversion, plus (2) the participant's accrued benefit for years of service after the date of the conversion, determined under the terms of the plan as in effect after the conversion. The Code thus prohibits the use of "wearaway" provisions that were used in a number of plan conversions in the past. In determining (1) above (*i.e.*, the participant's pre-conversion accrued

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benefit), the value of any early retirement benefit or subsidy for which the participant is eligible must be taken into account.

<u>No Whipsaw Effect</u>. As a result of the Act, the Code now protects plan sponsors from the "whipsaw effect." Under new section 411(a)(13)(A), for the purpose of calculating lump sums and certain other optional forms of payment, a plan can treat the present value of a participant's accrued benefit as being equal to the participant's hypothetical account balance or as an accumulated percentage of the participant's final average compensation. A plan need not project a participant's benefit forward to normal retirement age using the plan's interest rate assumptions and then discount it back using the Code-required interest rate.

Effective Dates

The provisions of new sections 411(b)(5) and 411(a)(13) apply prospectively only. Generally, the new rules apply for periods beginning on or after June 29, 2005. For plans in existence on that date, however, the vesting and interest crediting rules need not apply until plan years beginning in 2008, though a plan sponsor may elect to apply them earlier (but not earlier than June 29, 2005). The rule concerning the calculation of present values applies to distributions made after August 17, 2006. The rule prohibiting "wearaway" provisions in plan conversions is effective for plan conversions pursuant to amendments adopted and effective after June 29, 2005, though plan sponsors may elect to apply them to conversion amendments adopted before, but effective after, that date.

The prospective application of the changes made by the Act appears to derive from a respect for the separate and independent functions of the legislative and judicial branches of our government. The Act contains a specific provision stating that nothing in the amendments to the Code, ERISA or ADEA should be construed to create an inference with respect to whether hybrid plans and conversions of traditional defined benefit plans to hybrid plans resulted in age discrimination under previously existing law or whether hybrid plans that paid lump sum distributions based solely on the amount credited to a participant's account (*i.e.*, not on the calculation giving rise to the "whipsaw effect") satisfied the applicable requirements of the Code and ERISA as they existed at the time of the distribution.

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