GROOM LAW GROUP

February 5, 2008

MEMORANDUM TO CLIENTS

RE: Summary of Proposed Cash Balance Plan Regulations

On December 28, 2007, the IRS and Treasury issued much anticipated proposed regulations relating to cash balance and other hybrid plans. 72 Fed. Reg. 73680 (December 28, 2007) (the "Proposed Regulations"). The Proposed Regulations address many of the new rules applicable to these plans enacted in the Pension Protection Act of 2006 (the "PPA"). The regulations are an important first step towards developing a set of rules to address a number of difficult legal issues that have plagued hybrid plans for many years.

The Proposed Regulations address the primary changes made by the PPA, including:

- the general age discrimination standards for hybrid plans,
- the requirement that hybrid plans credit interest at no more than a "market rate of return,"
- the anti-"wear away" protections for plans converting to a hybrid formula after June 29, 2005,
- the 3-year vesting rule for hybrid plans, and
- the elimination of "whipsaw" calculations for lump-sum distributions from hybrid plans.

The Proposed Regulations begin to provide a detailed framework to implement these new rules, though a number of important issues remain unresolved. In general, once finalized, the regulations would be effective for plan years beginning on and after January 1, 2009. Plan sponsors may rely on the proposed regulations for the periods between the statutory effective date (generally June 29, 2005) and the effective date of the final regulations.

The IRS and Treasury have requested comments on the Proposed Regulations by March 27.

Below we summarize the Proposed Regulations and note a number of open questions.

I. New Defined Terms

The Proposed Regulations create the following new terms to describe the application of the new rules:

- "Accumulated benefit" means the benefit a participant has accrued to date as expressed under the terms of the plan, but does not include benefits that the

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participant has become entitled to, but not yet credited (e.g., future interest credits on the pay credits that a participant has already accrued).

- "Lump sum-based benefit formula" means a benefit formula expressed as the balance of a participant's hypothetical account (e.g., a cash balance plan) or the current value of the accumulated percentage of a participant's final average compensation (e.g., a pension equity plan). The determination of whether a formula is a lump sum-based benefit formula does not depend on the forms of payment available under the plan, but rather how a participant's benefit is expressed under the terms of a plan (a cash balance formula would be a lump sum-based formula even if it did not permit lump sum distributions of the hypothetical accounts).

- "Statutory hybrid benefit formula" means a lump sum-based benefit formula or a formula that has an effect similar to a lump sum-based benefit formula. Generally, this encompasses benefit formulas that include periodic adjustments to a participant's benefit and under which "the right to future adjustments accrues at the same time as the benefit that is subject to the adjustments." In this summary, we refer to these formulas as "hybrid formulas," and we refer to plans with a hybrid formula as "hybrid plans."

II. Age Discrimination Rules (Prop. Reg. Section 1.411(b)(5)-1)

The Proposed Regulations discuss the application of the following three new statutory rules under the Code's age discrimination provisions:

- a new safe harbor is provided to comply with the existing rule prohibiting the reduction of accruals on account of age,

- interest credits must be made at a rate that does not exceed a "market rate of return," and

- cash balance conversion amendments must not result in any "wear-away" periods.

A. Safe Harbor for Age Discrimination

General Rule – Code section 411(b)(1)(H) provides 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. Some have argued that hybrid plans may violate this general rule because the credit made to a younger participant's account will be more valuable than the same credit made to an older participant's account due to the additional years of interest until normal retirement age that will accrue for the younger participant.

Safe Harbor Rule – The PPA added new Code section 411(b)(5)(A) effective June 29, 2005, creating special age discrimination rules for hybrid plans that take into account the nature of these formulas. The statute states that "a plan shall not be treated as failing to meet the requirements of [the general rule described above] if a participant's accrued benefit, as determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant."

The Proposed Regulations characterize this rule as a "safe harbor" and provide that comparisons must be based on (1) an annuity payable at normal retirement age (or at current age, if later), (2) the 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. Comparisons 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 an annuity may not be compared to a participant whose benefit is expressed under the plan as a hypothetical account). The preamble requests comments on whether the safe harbor should be available to plans that express a participant's benefit in a manner other than one of these three permitted forms.

Similarly Situated – The statute states that similarly situated individuals are two individuals who are identical in every relevant aspect other than age, such as length of service, compensation amount, position, date of hire, and work history. The regulations give additional details on how the "similarly situated" criteria are applied. Any characteristic that is directly or indirectly based on age is disregarded. 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. The preamble requests comments on whether guidance should be issued regarding characteristics that are indirectly on account of age for purposes of determining who is similarly situated.

> *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 Proposed Regulations describe the application of the safe harbor to a plan under which more than one formula applies. If, under a plan, a participant's benefit equals the sum of benefits expressed as different forms, then the 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. In the case of comparing either the sum of or the greater of two benefits, the regulations specify that if a benefit formula does not apply to a similarly situated, *younger* participant, then that participant's accumulated benefit is treated as zero. (Interestingly, the regulations are silent as to whether an older, similarly situated participant's benefit must be treated as zero where the formula does not apply to the participant.)

For example, assume there are two similarly situated individuals in a plan that provides participants under age 50 as of a specified date with only cash balance benefits and provides older participants with the greater of the cash balance or traditional benefit. The younger participants (i.e., those under age 50) will be treated as having a traditional benefit of zero, and therefore, the safe harbor is met with respect to the traditional formula (because the older participants' benefit is greater). The cash balance benefit should also be eligible for the safe harbor because it applies to all 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 traditional formula benefit would pass the safe harbor, because the older, grandfathered participants would have a greater traditional benefit than similarly situated, younger participants who receive nothing under the traditional formula. The hybrid formula, however, would not pass the safe harbor. Younger, similarly situated participants' hybrid benefits would be greater than the grandfathered participants' nonexistent hybrid benefits. 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. A footnote to the preamble clarifies that if an election to be covered by a particular formula is extended to all participants, then those who made such election are similarly situated to others who made the election (with regard to that characteristic), and those who did not make the election are similarly situated with others who did not make the election.

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 the test), 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 regulations do not provide any insight into how the general rule might be applied to hybrid plans. However, much litigation has revolved around whether hybrid plans (in particular, cash balance plans) violate the general age discrimination rule. To date, several Circuit Courts of Appeals have held that the cash balance formula does not violate Code section 411(b)(1)(H). However, the district courts in the Second Circuit are split on the issue and appeals are pending.

Other Rules – Formulas With Offsets or Social Security Integration – The 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) and under ERISA. The second item relates to benefit formulas that are integrated with Social Security. 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).

Indexed Benefits – The regulations incorporate the provisions of Code section 411(b)(5)(E), which provides that certain indexing of benefits will not cause the plan to fail the general age discrimination test. 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 regulations limit application of the rule to defined benefit plans other than plans with lump sum-based formulas. The regulations provide an exclusive list of permitted indexing methodology, which includes (1) an eligible cost-of-living index as defined in Treasury Regulation section 1.401(a)(9)-6, A-14(b), (2) the rate of return on the aggregate assets of the plan, or (3) the rate of return on the annuity contract for the employees issued by an insurance company licensed under the laws of a State. It appears that a separate safe harbor test applies to indexed benefits. Rather than comparing the accumulated benefit, these plans must compare the aggregate periodic adjustments determined as a percentage of the unadjusted accrued benefit. As stated in the preamble, this safe harbor is available if the indexing is neither terminated nor reduced on account of the attainment of any age. The 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, but only if the adjustments are based on the second or third of the three permitted indexing methodologies described above.

Administration Issues – The regulations require that the safe harbor must be satisfied "as of any date." It is not clear whether an actual test must be performed or whether the safe harbor may be met by special attention to these rules in plan design. If actual testing is necessary, it is unclear how one would determine the universe of people who are *or could be* participants.

B. Interest Crediting Rules

General Rule – The PPA added new Code section 411(b)(5)(B)(i), which provides that a hybrid plan fails the age discrimination test unless it uses an interest crediting rate that is not greater than a market rate of return. The statute also provides that it does not prohibit a plan from establishing a reasonable minimum guaranteed rate of return or from using the greater of a fixed or variable rate of return. This statutory change is generally effective for years beginning after December 31, 2007 (for plans not in existence on June 29, 2005, this change is effective as of June 29, 2005).

Market Rate of Return Definition – The regulations do not offer much new insight into what is meant by a market rate of return. Instead, they reiterate the specific rates that were listed in IRS Notice 2007-6 as market rates of return (referred to in this summary as "designated market rates"). These rates include (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, and (3) the rate of interest on long-term investment grade corporate bonds. Effective January 1, 2008, the corporate bond rate designated as a market rate is the third segment bond rate, determined with or without the transition rules described in Code section 430(h)(2)(G). Note that this refers to the third segment corporate bond rate described in Code section 430, which is different than the third segment corporate bond rate described in Code section 417(e) relating to the valuation of lump sum payments. Prior to January 1, 2008, the designated corporate bond rate was the rate described in Code section 412(b)(5)(ii)(II).

Lower Rates – The regulations clarify that lower rates are permitted, provided that they are always less than one of the designated market rates.

Fixed Rates – The preamble indicates that the IRS and Treasury are considering allowing plans to use a fixed rate for interest crediting. Permissible fixed rates could be set by the IRS (the preamble suggests four percent or five percent). Alternatively, the IRS could set a methodology for plans to select a fixed rate (such as the currently applicable rate of one of the designated market rates). However, the preamble raised the concern that plans might set a fixed rate when interest rates are unusually high, which would circumvent the entire purpose of the market interest rule. The IRS and Treasury request comments on these suggested methods.

Equity-Based Rates – The regulations contain a placeholder for "equity-based rates" as acceptable crediting rates. The concern described in the preamble is that when combined with the capital preservation rule (described below), an equity-based rate may exceed the market rate of return limitation. For this reason, the preamble discusses allowing an interest rate based on an asset portfolio (including the actual plan assets) that is sufficiently diversified and therefore has "sufficiently limited volatility," and only if it is used prospectively and is chosen prior to the period during which the rate is determined. The IRS and Treasury request comments on what asset portfolios might be permitted. For example, a rate based on assets under a regulated investment company (RIC) or an equity index that is not too narrow might be considered.

Combination of Rates – The regulations recognize the option of using the greater of two or more different interest rates. In this case, each of the interest rates selected must not exceed one of the designated market rates. In addition, one or both of the rates must be adjusted (exclusively in the manner to be provided in the final regulations) to ensure that the resulting rate does not exceed a market rate. The regulations do not describe what such adjustment might entail, but they request comments on what types of reduction might be appropriate, and whether such reduction should be made under plans in which the "greater than" determination is made more frequently than annually.

The preamble discusses the problems raised by greater-of interest formulas. For example, the greater of a fixed rate (including zero percent) and an equity-based index would, according to the preamble, "typically" result in a rate that exceeds a market rate. The greater of a zero percentage fixed rate and the actual rate of return on plan assets applied on a daily basis "would be far in excess of a market rate of return." However, the greater of a reasonable fixed rate (such as three percent or four percent) and one of the designated market rates may be acceptable. The regulations do not address "lesser-of" rates. Presumably, lesser-of rates should be permissible, if one of the rates is equal to or always lower than a designated market rate. The regulations also contain a placeholder for a "reasonable minimum guaranteed rate of return" (which is specifically permitted by the statute).

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. The 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. The preamble notes that crediting rates may be negative in some years. However, this rule is "premised on the expectation that the variable rate would rarely be negative for extended periods of time" (in other words, the application of this rule should not significantly increase the effective rate of return).

Timing Issues – The regulations provide that a plan must state when it will determine the interest crediting rate – using either a daily interest crediting rate or a specified lookback month and stability period. The lookback month and stability period must satisfy the requirements of Treasury Regulation section 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), but they need not be the same as those used under the plan for valuing lump sums under Code section 417(e)(3) purposes. The interest rate must change 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 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% must calculate the monthly credits based on a rate of .5%). Compounding of interest will not cause an otherwise permissible rate to exceed the market rate of return limitation.

Interest Crediting Rate Definition – The regulations broadly define the phrase "interest crediting rate" as the rate by which a participant's benefit is increased under the plan, to the extent not conditioned on current service. This definition could bring into consideration other types of contributions, even if they are not made by reference to a rate of return or an index, provided they are not conditioned on current service. On the other hand, 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 not be included in the definition, and therefore such credits would be considered as 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.

Cutback Issues – The regulations state that an amendment to change the 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. There is an exception for plans changing from a designated market rate to the corporate bond designated market rate, provided that the effective date is not more than thirty 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.

Another exception exists for plans changing from one of the Notice 96-8 safe harbor rates to another Notice 96-8 safe harbor rate, provided that the new rate is not "further" from the maximum associated margin than the old rate. In other words, a safe harbor rate using the maximum associated margin may be changed to another safe harbor rate, but the new rate must also use the maximum margin associated with that rate. Similarly, for example, a safe harbor rate using a margin 50 points below the maximum margin for that rate may be changed to another safe harbor rate using a margin that is between (1) 50 points below the maximum margin and (2) the maximum margin. The regulations reserve a section for other exceptions, and the preamble states that it is expected that future guidance will provide additional "cutback" relief allowing a plan to change its crediting rate from an above-market rate to a rate that is a market rate.

Uncertainties – The preamble strongly admonishes plan sponsors, pending further guidance, to "be cautious in adopting interest rates other than those explicitly permitted in these proposed regulations." Plan sponsors must think ahead and proceed with caution when selecting a crediting rate, because the lack of broader cutback relief makes the selection somewhat permanent (at least for interest credits on accrued amounts). Additional guidance on market rate of return is expected later this year. Until then, the safest choice appears to be using one of the designated market rates.

Special Rules For Plan Terminations – Upon termination of a hybrid plan, a participant's benefit must be determined using the interest rate and mortality table otherwise applicable for determining the plan benefit, without regard to the termination. The regulations describe an exception for plans that use variable interest rates. Upon termination of such plan, any variable interest rate used to determine plan benefits, including the interest crediting rate and the rate used to determine annuity benefits, is determined as the average of the rates of interest used under the plan for that purpose during the 5-year period ending on the termination date.

III. Conversion Protection (Wear-Away Prohibition)

General Rule – Many sponsors of plans with traditional formulas converted to hybrid formulas by converting the benefit accrued under the traditional formula into an amount that is used as the opening balance under the hybrid formula. The PPA added new Code sections 411(b)(5)(B)(ii), (iii), (iv) and (v), creating special rules for the conversion of plan formulas to hybrid plan formulas. If the requirements are not met, then the hybrid plan will be deemed to violate the age discrimination rules.

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 regulations implement this rule and provide additional guidance on its application, including a number of illustrative examples.

Application – For the A+B calculation, the two portions must each 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.

Effective Date – Under the statute, the A+B conversion requirement applies to conversion amendments adopted after June 29, 2005. The Proposed 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.

The effective date provisions raise a number of questions. For example, for a plan that was amended prior to June 29, 2005, but that provided for the continuation of the prior traditional benefit for some number of years, which period ends after June 29, 2005, the *effective* date of the amendment for purposes of the regulations would be after June 29, 2005. Presumably, such a plan would not be subject to these A+B conversion requirements, however, because the amendment at issue was *adopted* before June 29, 2005. However, it is unclear how the IRS would apply the regulations in this situation. A variation of this issue applies for participants who transfer from a position covered by a non-hybrid formula to a position subject to the hybrid provisions of the plan. In this situation, the regulations state that "there has been a conversion amendment as of the date of transfer." It is not clear whether this date is treated as (1) both the adoption date and the effective date of the amendment, or (2) only as the effective date of the amendment. If the former, then pre-June 29, 2005 conversions would become subject to the A+B requirements for these type of post-June 29, 2005 employment transfers.

Consolidation Rules – The Proposed 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. 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.

Alternative Conversion Approaches – The Proposed Regulations permit a plan to establish an opening balance (i.e., to convert the prior accrued benefit to an initial balance under the new hybrid formula) provided that it separately tracks (1) the opening balance and the interest credits attributable to that amount, and (2) the post-conversion hybrid formula accruals. On a participant's annuity starting date, the plan must ensure that the amount attributable to the opening balance is greater than or equal to the benefit accrued under the plan prior to the conversion, by comparing these two amounts as determined under the optional form elected by the participant – regardless of whether the form elected was available as an option under the prior plan provisions (for example, if the participant elects to receive a lump-sum payment and a lump sum was not an available form prior to the conversion).

The IRS requests suggestions for other alternatives for exempting opening balance conversions from the A+B rule that would not require the later comparison. Such alternatives must provide adequate protection to participants. The preamble describes a possible alternative that may not require a later comparison, provided that (1) the opening balance equals the present value of the pre-conversion benefit, "determined in accordance with Code section 417(e)," (2) interest credits on the opening balance are "reasonably expected to be no lower than the interest rate used to determine the opening balance," and (3) "either the plan provides a death benefit equal to the hypothetical account balance or no pre-retirement mortality decrement is applied in establishing the opening hypothetical account balance." This example could result in an amount attributable to the opening account balance being lower or higher than the present value of the pre-conversion amount.

IV. Other Hybrid Plan Requirements – Vesting and Whipsaw (Prop. Reg. Section 1.411(a)(13)-1)

In addition to the age discrimination rules described above, the regulations describe additional provisions that apply to hybrid plans, including new vesting rules and the elimination of whipsaw.

A. Vesting Rules

The PPA added new Code section 411(a)(13)(B) to require that participants become fully vested under a hybrid plan upon the completion of three years of service. Under the Proposed Regulations, the determination of whether the three-year vesting rule applies is made on a participant-by-participant basis. 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. The preamble requests comments regarding how the vesting requirement should be applied to a plan that is not a hybrid when that plan is part of a floor-offset arrangement with a plan that includes a lump sum-based benefit formula. For example, would the 3-year vesting rule apply to a traditional pension plan if that plan has an offset arrangement with another plan that is a hybrid plan?

Effective Date – 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 January 1, 2008. For plans not yet in existence on June 29, 2005, the new vesting rule applies upon the plan commencement. The regulations contain a placeholder for an hour of service requirement with regard to the effective date. A pending technical correction bill, if adopted, would provide that the accelerated vesting rules would apply only to a participant who has an hour of service on or after the effective date of the new vesting requirement. As originally enacted, it is unclear whether the new vesting rule would apply to all participants on the effective date, including those who are not actively employed at that time. 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 January 1, 2010).

B. Whipsaw and Lump Sum Distributions

Code section 417(e) generally requires that lump-sum distribution amounts from DB 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. The PPA added new Code section 411(a)(13)(A), which 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.

The Proposed Regulations 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.

The elimination of whipsaw was generally effective with respect to distributions made after August 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).

V. Pension Equity Plans and Other Non-Cash Balance Formulas

The Proposed Regulations generally do not address pension equity plans (other than defining a participant's accrued benefit as the accumulated percentage of final average compensation). In the preamble, the IRS and Treasury specifically request comments regarding the application of the rules to these plans. The IRS received a number of comments in response to Notice 2007-6. However, as they continue to struggle with the application of the rules to these plans, they specifically would like comments on the following: (1) considering the design of these plans, are they properly treated as expressing benefits "as an accumulated percentage of the participant's final average compensation" or "as the balance of a hypothetical account," (2) do such designs provide for a lower rate of accrual for additional years of service, possibly in violation of Code section 411(b)(1)(G), and (3) how should the anti-backloading rules apply to these plans.

VI. Next Steps

As noted above, the Proposed Regulations raise many questions and leave many issues unaddressed. The preamble lists a number of specific items on which the IRS would like comments, which are described throughout this summary. If you are interested in submitting comments to the IRS or if you have any questions about hybrid plan issues, please call one of the following or the firm attorney you regularly contact.

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