IRS Regulations on “Hybrid” Retirement Plans

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Since the latter part of 2010, the Internal Revenue Service (IRS) has been active in the area of "hybrid" defined benefit pension plans, such as cash balance plans and pension equity plans (PEPs). These plans are referred to as “hybrid” plans because they are defined benefit plans that may express the accrued benefit under the plan in a manner similar to defined contribution plans, such as by reference to a hypothetical account balance. The Pension Protection Act of 2006 (PPA) revised the Internal Revenue Code (the Code) to change the way the Code’s vesting and accrual rules apply to hybrid plans. The IRS’s recent activity relates to these new provisions of the Code.

Perhaps the most dominant trend in retirement plans in the past 20 years or so has been the decline of defined benefit plans in favor of defined contribution plans. Hybrid plans may appeal to plan sponsors looking for a middle ground by designing defined benefit plans with certain defined contribution features, such as benefits based on a hypothetical account balance and the portability that comes with defined contribution plans. The road, however, has not always been smooth, with litigation alleging that cash balance plans violate the Code’s age discrimination prohibitions and challenging the way interest crediting rates and interest assumptions used in calculating benefits under cash balance plans (the so-called “whipsaw” issue).

In October 2010, the IRS issued (a) final regulations interpreting new Code sections relating to vesting and benefit accrual for hybrid plans (the final rules) and (b) proposed regulations providing additional interpretations relating to those Code sections (the proposed rules). Initially, the final rules would have required amendments to have been made to reflect certain of the new provisions by the end of 2010. In December, 2010, however, the IRS extended this deadline to the end of the 2011 plan year (December 31, 2011 for calendar-year plans), although plans must be operated in compliance with the new requirements. Comments on the proposed rules were due on January 12, 2011 and a public hearing on the proposed rules was held on January 26, 2011.

These provisions are quite technical. Rather than providing a detailed discussion of the technical requirements, this column outlines some of the higher level ideas and themes so that plan sponsors with hybrid plans can confirm with their advisers that appropriate amendments have been made, or are being made, and plan sponsors considering adopting hybrid plans can begin (or continue) the conversation with their professional advisers in light of the recent developments.

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Final Rule
Like other types of qualified plans, hybrid plans must meet the Code’s minimum vesting standards in Section 411(a) and the benefit accrual standards in Section 411(b). Aspects of these requirements, however, may present issues for hybrid plans and the new Code provisions added by the PPA provided certain modifications for hybrid plans. The final rules address Code Section 411(a)(13) and Code Section 411(b)(5), both of which were added by the PPA.

Section 411(a)(13)—Relief from Vesting Requirements, Definitions and Special Vesting Rule

Relief from Vesting Requirements. Section 411(a)(13) provides relief from certain of the Code’s otherwise applicable vesting requirements for “statutory hybrid plans that determine benefits under a lump sum-based benefit formula.” Obviously, the definitions of these terms are key to this provision.

Definitions. The final rule includes a set of interlocking definitions that resemble those Russian nesting dolls in that it seems that each of the defined terms contains another defined term inside of it. A “statutory hybrid plan” is defined as a “defined benefit plan that contains a statutory hybrid benefit formula.”

A “statutory hybrid benefit formula” is, in turn, a benefit formula that is a “lump sum-based benefit formula or a formula that is not a lump sum-based benefit formula but that has an effect similar to a lump sum-based benefit formula.”

Opening the next level of the nesting dolls, the regulations provide that a “lump sum-based benefit formula” is a benefit formula “under which the accumulated benefit provided under the formula is expressed as the current balance of a hypothetical account maintained for the participant or as the current value of an accumulated percentage of the participant’s final average compensation.” The regulation further provides that a benefit formula is expressed as a current balance of a hypothetical account if is expressed as a single-sum dollar amount. It does not depend on the plan actually providing a form of benefit in the form of a single-sum payment. A formula has “an effect similar to a lump sum-based benefit formula” if the formula provides that the participant’s benefit includes the right to adjustments for future periods and the total dollar amount of those adjustments is reasonably expected to be smaller for the participant than for a similarly situated younger participant.

Special Vesting Rule. Section 411(a)(3) also applies special vesting rules for defined benefit plans with an accrued benefit (or portion of an accrued benefit) determined under a statutory hybrid benefit formula. In that case, the plan must provide that the participant is fully vested in the participant’s accrued benefit derived from employer contributions if the participant has three or more years of service. The final rule clarifies that this vesting requirement applies to the participant’s entire accrued benefit even if only a portion of the accrued benefit is determined under a statutory hybrid benefit formula.

Section 411(b)(5)—Safe Harbor for Age Discrimination: Accumulated Benefits, Plan Conversion and Interest Crediting

Safe Harbor for Age Discrimination. Under the Code, defined benefit plans are generally not permitted to stop or reduce benefit accruals once a certain age is achieved. There had been
arguments that cash balance plans violate this provision because older workers tended to have accrued interest credits than younger workers, resulting in a lower rate of benefit accrual. The PPA set forth a “safe harbor,” meaning that plans that satisfy certain conditions will be treated as satisfying the age discrimination rule.

The safe harbor has three general conditions—comparable accumulated benefits for older and younger employees, interest credits not exceeding a market rate of return and plan conversion amendments in compliance with PPA.

First, accumulated benefits under the plan for a given participant must be no less than the accumulated benefit of any similarly situated, younger individual. “Similarly situated” is defined as “identical to that other individual in every respect that is relevant in determining a participant’s benefit under the plan . . . except for age.” The final rule provides that a plan will not be treated as violating the accumulated benefit requirement of the safe harbor solely because the plan provides for adjustments to benefits through a recognized index or methodology.

Second, the age discrimination safe harbor also imposes a number of technical requirements on a plan’s conversion from non-hybrid to hybrid status. The requirements are intended to prevent a participant from losing protected benefits as a result of the conversion. In other words, a participant at the time of the conversion must have a benefit after the conversion that is not less than the participant’s “pre-hybrid” protected benefit plus the participant’s “post-hybrid” protected benefit.

Finally, the final rule provides that a plan will not satisfy the age discrimination safe harbor unless it provides for an interest crediting rate that is not greater than a market rate of return. An interest crediting rate is used under hybrid plans to determine the hypothetical account balance. The final rule specifies certain crediting rates that will be deemed not to exceed a market rate of return. The final rule also includes certain requirements regarding the how and when interest credits will be made, requiring that they be credited no less frequently than annually.

Proposed Rule
Simultaneously with the final rule, the IRS issued the proposed rule addressing certain additional topics related to those in the final rule. Among the topics addressed in the proposed rule are:

- Additional limitations on the relief from the vesting rules, including requirements that a lump sum-based benefit formula must satisfy to obtain relief, as well as rules extending the relief to forms of benefit other than a lump sum.
- Application of the benefit accrual rules for hybrid plans with variable interest rate crediting.
- Additional rules relating to plan conversions and the calculation of the participant’s benefit upon the conversion.
- Relief from the application of the Code’s “anti-cutback” rules to changes in the interest crediting rate.

The IRS received approximately 25 comments on the proposed rule from plan sponsors, attorneys, actuaries and benefit consultants. The IRS held a public hearing on the proposed
rule on January 26 at which nine speakers provided testimony on the proposed rule. The IRS anticipates that the proposed rules will become effective for plan years beginning on or after January 1, 2012, but it remains to be seen what changes will be made in response to the comments and the testimony on the proposed rules.

Those plan sponsors with hybrid plans will want to stay in close contact with their advisers to monitor developments in this complex and technical area. Those plan sponsors considering adopting or converting to a hybrid plan may benefit from the additional clarity provided on certain points but, as the proposed rule reflects, not every question is yet settled.

Notes
5. Treas. Reg. § 1.411(b)(5)-1(b)(5).