ASAP™ A Littler Mendelson **Time Sensitive** Newsletter

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IRS Announces Long-Stalled Determination Letter Process Will Open With Respect to Cash Balance Plans and Provides Other Guidance

By Susan Katz Hoffman

On January 16, 2007, the Internal Revenue Service will issue Notice 2007-6, announcing that it will begin processing determination letters for cash balance conversions (and for similar account-balance defined benefit plans, now called "statutory hybrid plans").

In 1999, the IRS suspended processing of determination letters for cash balance conversions amid legislative and judicial controversy over the age discrimination implications of such conversions. In the Pension Protection Act of 2006 (PPA), Congress provided that such plans would not be age discriminatory if certain guidelines were met, and the Internal Revenue Code, ERISA, and the Age Discrimination in Employment Act were all amended to include guidance for such conversions. A new methodology was prescribed for testing statutory hybrid plans under age discrimination rules. The PPA also clarified how hybrid plan sponsors could avoid the "whipsaw effect" under which the benefit owed to a participant could exceed his or her plan account balance.

For additional information regarding recent hybrid plan developments, see Littler ASAP *Cash Balance Comeback-New Opportunities for Employers in Wake of Court Decision and New Legislation*.

The PPA expressly stated, however, that it was not intended to provide any guidance with respect to these rules before the effective date of the new age discrimination rules (June 29, 2005). Additionally, the effective date of the new rules relating to post-PPA conversions from traditional defined benefit plans, and the elimination of the "whipsaw effect" problem, is the date of enactment of the PPA (August 17, 2006).

The PPA provided that regulatory guidance would be required in connection with certain aspects of these plans. Notice 2007-6 does provide some helpful guidance, but leaves many questions unanswered at this time. We have provided in Q&A form below our analysis of some of the most salient provisions of the new guidance.

Plan's Definition of Accrued Benefit

Q: A pre-PPA cash balance plan may define the accrued benefit not as a participant's account balance but as the actuarial equivalent of the account balance, in the form of an annuity commencing at age 65. This definition was thought to be required under the pre-PPA benefit accrual rules of the Code. Will this plan still be a statutory hybrid plan under the PPA?

A: Yes. Notice 2007-6 defines a statutory hybrid plan as a plan that is lump sum-based or that has a similar effect. If the accumulated benefit of a participant is expressed as the balance of a hypothetical account, or the current value of an accumulated percentage of the participant's final average compensation, or the actuarial equivalent of such an account balance or accumulated percentage, the plan is a statutory hybrid plan. The Notice also specifies that if the plan defines the accrued benefit as the normal retirement age annuity that is the actuarial equivalent of the account balance, it is still a statutory hybrid plan under the PPA.

Q: A pre-PPA pension equity plan defines the accrued benefit as the accumulated percentage of the participant's final average compensation, but does not provide for a lump sum option. Will this plan be a statutory hybrid plan under the PPA?

A: Yes. This type of plan is treated as having a similar effect to a lump sum-based plan, and therefore is a statutory hybrid plan.

Plan's Interest Crediting Rate

Q: A pre-PPA cash balance plan pays the cash balance as a lump sum distribution, but the interest crediting rate was not a safe harbor rate under prior IRS guidance contained in Notice 96-8. So the plan has been paying the higher lump sum produced by projecting the account balance forward to age 65 and then calculating the present value under the statutory interest rate (the "whipsaw effect"). Can we change this to eliminate the whipsaw?

A: Yes. The PPA eliminated the whipsaw effect for distributions made after August 17, 2006. Even though the Code generally prohibits amendments that reduce accrued benefits and distribution rights, Notice 2007-6 provides relief from this prohibition, and the amendment will not operate as a prohibited benefits cutback under Code section 411(d)(6) if it is amended to eliminate the higher distribution right on or before the last day of the first plan year beginning on or after January 1, 2009 (or January 1, 2011 for a governmental plan). The amendment may be retroactive as far back as August 17, 2006. But if this amendment significantly reduces the rate of future benefit accrual, section 204(h) of ERISA and section 4980F of the Code require 30-days' advance notice before the amendment is effective. Also, in reviewing pre-PPA cash balance plans, the IRS will require compliance with Notice 96-8 for pre-PPA distributions.

Q: Does Notice 2007-6 provide a safe harbor for the interest crediting rate?

A: Yes. Pending further guidance, a cash balance plan can use the rate of interest on long-term investment grade corporate bonds for plan years prior to January 1, 2008, and the third segment rate (as described in Code section 430(h)(2)C(iii)) thereafter, or the rate of interest on 30-year Treasury securities, or the sum of any of the standard indices and associated margin for that index that were previously provided as safe harbors under Notice 96-8.

Age Discrimination Issues Predating New Age Discrimination Rules

Q: If the IRS is now going to process the suspended determination letter applications (for "moratorium plans"), will a favorable determination letter provide any defense against age discrimination litigation relating to benefits accrued after June 29, 2005?

A: Unfortunately, Notice 2007-6 is not clear on this point. A moratorium plan will be reviewed as to whether post-conversion accruals satisfy the requirements of section 411(b)(1)(H), but the IRS will not address the question of whether a pre-PPA conversion satisfies the requirements of that section prior to amendment by the PPA (including the effect of any wearaway). Since most age discrimination cash balance litigation has attacked the post-conversion accrual design of cash balance plans, a favorable determination letter that approves the post-conversion accrual design under the PPA version of that section should provide some protection against claims relating to accruals after June 29, 2005. But the language limiting the scope of the IRS review of the conversion is unclear.

Guidance Regarding Terminated Plans

Q: What about terminated cash balance plans?

A: If the termination date was after August 17, 2006, the provisions of the PPA can be used to ensure that the plan has satisfied all benefit liabilities. If the termination date was before August 18, 2006, the PBGC has advised the IRS that the new lump sum payment calculation rules cannot be used to determine benefit liabilities. The guidance is silent on how the PPA rules relating to age discrimination can be used with respect to a plan that terminated before the enactment of the PPA.

Littler to Comment on Guidance

Q: Are there more questions that need to be answered?

A: Plenty of them. Below are a few that the IRS has identified. Comments are requested and can be submitted by April 16, 2007. We will be working on a set of comments and would be pleased to receive input from affected clients.

- When will two or more amendments, or the coordination of two or more defined benefit plans, have the effect of a conversion into a statutory hybrid plan?
- How should a market rate of return be defined for purposes of the safe harbor crediting rates?
- What effect does the minimum rate of return rule in the PPA have on the definition of a market rate of return?
- What effect does the preservation of capital rule have on the definition of a market rate of return (this rule may restrict the use of a negative rate of return)?
- How does the anti-cutback rule of section 411(d)(6) apply to an amendment to the interest crediting rate, and under what circumstances should relief be provided?
- How should the special hybrid plan rules apply where only some participants are covered by the hybrid plan formula, or where only a portion of a participant's benefit is subject to the hybrid plan formula, or where the hybrid plan formula is offset by (or offsets) the benefit provided under another plan?
- How do other qualification requirements apply to a hybrid plan where the accrued benefit is calculated as an accumulated percentage of the participant's final average compensation (a "pension equity plan")?
- How should indexed plans be defined for application of the new statutory hybrid plan rules?

Littler will continue to provide updates and guidance as these issues develop. Please contact any of the attorneys in Littler's Employee Benefits Practice Group if you would like assistance in addressing the issues discussed in this newsletter.

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