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A legal update from Dechert's Employee Benefits and Executive Compensation Group

IRS Issues New Regulations for Hybrid Retirement Plans

The Internal Revenue Service ("IRS") recently issued final regulations under Sections 411(a)(13) and 411(b)(5) of the Internal Revenue Code of 1986, as amended (the "Code"), providing guidance with respect to the minimum vesting standards and accrual requirements for hybrid defined benefit pension plans. These regulations generally apply to plan years beginning on or after January 1, 2011. For periods between the effective date of Code Sections 411(a)(13) and 411(b)(5) (generally, June 29, 2005) and the effective date of the final regulations, plan sponsors may rely on the final regulations.

Hybrid Plans: Background Information

A hybrid plan is a defined benefit pension plan that has features of both a defined benefit plan and a defined contribution plan. Two common forms of hybrid plans are cash balance plans and pension equity plans. Like all tax-qualified retirement plans, hybrid plans must comply with the minimum vesting standards of Code Section 411(a) and the accrual requirements of Code Section 411(b). However, the Pension Protection Act of 2006 modified these sections of the Code to provide special rules for hybrid plans. These modifications generally provide that a hybrid plan will not fail to satisfy the vesting, accrued benefit, age discrimination and other rules of Code Sections 411 and 417 as long as certain requirements are met.

Final Regulations Under Code Section 411(a)(13)

Definition of Hybrid Plan

The final regulations define a hybrid plan as a defined benefit pension plan that contains a "statutory hybrid benefit formula," which is a benefit formula that is either a lump sum-based benefit formula or a formula that has an effect similar thereto. A lump sum-based benefit formula is a benefit formula that expresses a participant's accumulated benefit as either 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, regardless of whether the plan provides for an optional lump sum benefit payment.

A benefit formula has an effect similar to a lump sum-based benefit formula if the formula provides that a participant's accumulated benefit is expressed as a benefit that includes the right to adjustments for a future period and the total dollar amount of those adjustments is reasonably expected to be smaller for the participant than for a similarly situated, younger individual. Adjustments may be provided pursuant to a formula in the plan or may be deemed to occur as the result of a pattern of repeated plan amendments. Post-annuity starting date adjustments, such as cost of living increases, are generally disregarded in

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determining whether a benefit formula has an effect similar to a lump sum-based benefit formula.

Applicability of Vesting Requirements

Under Code Section 411(a)(13), a hybrid plan must provide that participants will be 100% vested in employer contributions by no later than the date on which they are credited with three years of service. The final regulations clarify that even if only a portion of a participant's accrued benefit is determined by using a hybrid benefit formula, the three year vesting requirement will apply to the participant's entire accrued benefit. The three year vesting requirement will also apply to a participant's entire accrued benefit if the participant's accrued benefit is determined as the greater of a hybrid benefit formula and one or more non-hybrid benefit formulas, regardless of which formula is ultimately used to provide the participant's benefit. However, the final regulations provide that the three year vesting requirement will not apply to a participant's entire accrued benefit if the participant's accrued benefit under a hybrid plan is merely used to offset the participant's accrued benefit under a non-hybrid plan. In such an event, the three year vesting requirement will apply only to the participant's accrued benefit under the hybrid plan.

Final Regulations Under Code Section 411(b)(5)

Safe Harbors for Certain Plan Designs

General

The final regulations provide safe harbors for certain plan designs that are deemed to satisfy the age discrimination rules of Code Section 411(b), which generally require that an employee's benefit accrual not cease, or the rate of accrual not be reduced, because of the attainment of any age by the employee. Most notably, safe harbors are provided for (i) accumulated benefit testing and (ii) indexed benefits.

Accumulated Benefit Testing

Code Section 411(b)(5) provides that a hybrid plan will be treated as violating the age discrimination rules of Code Section 411(b) unless the participant's accumulated benefit as of any date would be equal to or greater than that of any similarly situated, younger individual. Accordingly, in order to determine whether this rule is satisfied, each participant's accumulated benefit must be compared to the accumulated benefit of each such younger individual. The final regulations provide that the following safe harbor benefit measures may be used to perform such comparison:

- an annuity payable at normal retirement age (or current age, if later);
- the current balance of a hypothetical account maintained for the participant; and
- the current value of an accumulated percentage of the participant's final average compensation.

Generally, in order to be eligible to use a safe harbor benefit measure, the participant's accumulated benefit under the plan must be expressed in terms of only one of the safe harbor benefit measures and no similarly situated, younger individual may have an accumulated benefit expressed in terms of a different benefit measure. However, the final regulations include detailed rules regarding how to make this comparison if a participant's accumulated benefit is determined under multiple benefit formulas.

Indexed Benefits

The final regulations provide that a hybrid plan will not be treated as violating the age discrimination rules of Code Section 411(b) solely because a benefit formula (other than a lump sum-based benefit formula) under the plan provides for the periodic adjustment of the participant's accrued benefit by means of the application of a recognized index or methodology. A rate that does not exceed a market rate of return (as described below) is deemed to be a recognized index or methodology. In order to be eligible for this safe harbor, the aggregate adjustments made to a participant's accrued benefit in a period cannot be less than the aggregate adjustments made for any similarly situated younger participant for that period.

Plan Conversion Amendments

General

The final regulations provide rules regarding when a non-hybrid plan will be deemed to be amended to become a hybrid plan. Such amendments are referred to as "conversion amendments." An amendment will be deemed to be a conversion amendment if (i) the amendment has the effect of reducing or eliminating benefits that, but for the amendment, the participant would have accrued after the amendment effective date under a non-hybrid benefit formula and (ii) after the amendment, all or a portion of the participant's benefit accruals are determined under a hybrid benefit formula. The final regulations clarify that only amendments that reduce or eliminate accrued benefits described in Code Section 411(a)(7), or retirement-type subsidies described in Code Section 411(d)(6), that would have otherwise accrued as the result of future service will be treated as conversion amendments. A conversion amendment will be deemed to be effective on the date on which the participant's future benefit accruals under a non-hybrid benefit formula are reduced or eliminated. Examples of actions that may be deemed to be a conversion amendment include:

- a change in a participant's employment status (for example, by transferring from a division that provides retirement benefits using a non-hybrid benefit formula to a new division that provides retirement benefits using a hybrid benefit formula);

- the adoption of an amendment under which a participant's benefits under a non-hybrid plan are coordinated with benefits under a hybrid plan; and

- the adoption of multiple plan amendments that, in the aggregate, have the effect of a conversion amendment.

Benefits Following a Conversion Amendment

If a conversion amendment is adopted, the final regulations require that the benefit of an individual who was a participant immediately prior to the adoption of the conversion amendment not be less than the sum of:

- the participant's protected benefits based on the plan terms and years of service before the effective date of the amendment, and

- the participant's protected benefits based on the plan terms and years of service after the effective date of the amendment.

The final regulations also include relief that permits a sponsor to replace a participant's pre-conversion protected benefits with an initial amount credited to a hypothetical account for the participant or with an initial accumulated percentage of the participant's final average compensation. In this scenario, the plan must provide that if such action has the effect of decreasing the participant's pre-conversion protected benefits when his or her annuity starting date occurs, the participant's initial account balance or initial accumulated percentage of final average compensation, as the case may be, must be increased by the amount necessary to eliminate any disadvantage to the participant of such replacement.

Interest Crediting

General

The final regulations provide that a hybrid plan will not satisfy the age discrimination rules of Code Section 411(b) unless the plan provides for an interest crediting rate that does not exceed a market rate of return. An "interest credit" generally means an adjustment to a participant's accumulated benefit to the extent not conditioned on current service or made on account of imputed service. However, a plan amendment providing for a one-time adjustment to a participant's accumulated benefit is not an interest credit.

Market Rate of Return

Under the final regulations, an interest crediting rate will not exceed a market rate of return if the plan provides that the interest crediting rate for each plan year is determined using one of the following specified interest crediting rates:

- the interest rate on long-term investment grade corporate bonds;

- an interest rate equal to the sum of the interest rate for certain bonds (such as 1, 3, 7 or 30 year Treasury bonds), plus the associated margin for that interest rate, as specified in the final regulations;

- a rate of interest that is adjusted no less frequently than annually and that is equal to the rate of increase with respect to an eligible cost of living index described in the Code, increased by 300 basis points;

- in the case of indexed benefits, an interest crediting rate equal to the actual rate of return on the aggregate assets of the plan, provided that the plan's assets are diversified to minimize the volatility of returns; or

- unless determined otherwise by the IRS, the rate of return on the annuity contract for the participant issued by an insurance company licensed under state laws.

A plan may also provide that the interest crediting rate will not exceed any of the above specified interest crediting rates.

Interest Crediting

The final regulations require a hybrid plan that provides interest credits to specify how the interest credits will be determined and how and when interest credits will be made. In addition, interest credits must be credited no less frequently than annually and must be made as of the end of the relevant period. If interest credits determined by reference to the interest rate on long-term investment grade corporate bonds are made more frequently than annually, then the interest credited with respect to any period may not exceed a pro-rata portion of the applicable annual interest rate (for example, if the annual interest rate is 6% and interest is credited monthly, interest credited during any month may not exceed .5%).

Protected Benefits

Under the final regulations, the right to interest credits that are not conditioned on future service constitutes a Code Section 411(d)(6) protected benefit. As the result, to the extent that benefits have accrued under the terms of a hybrid plan that entitle a participant to future interest credits, an amendment to that plan to change the interest crediting rate to a rate that could result in interest credits that are smaller than if no such amendment had occurred must generally comply with the protected benefit rules under Code Section 411(d)(6). However, the final regulations do contain exceptions to this rule. For example, a plan may change from using one of the safe harbor bond-based interest crediting methods to long-term investment grade corporate bond rates, provided that (i) the amendment applies only to interest credits to be made after the amendment effective date, (ii) the effective date of the amendment is at least 30 days after its adoption and (iii) on the effective date of the amendment, the post-amendment interest crediting rate is not lower than the pre-amendment interest crediting rate.

Proposed Regulations

In connection with the issuance of the final regulations, the IRS also issued proposed regulations under Code Sections 411(a)(13), 411(b)(1) and 411(b)(5). These proposed regulations address several items that were not covered in the final regulations, including:

- satisfaction of the benefit accrual rules under Code Section 411(b)(1) for hybrid plans that use variable interest rate crediting;
- additional requirements that must be satisfied in order to qualify for the relief provided in Code Section 411(a)(13) (such as restrictions on the reduction of a participant's hypothetical account balance or accumulated percentage of final average compensation);
- additional requirements regarding the calculation of a participant's benefit in the event of a conversion amendment; and
- additional guidance regarding interest crediting (such as the timing and calculation of interest credits, interest rates that meet the market rate of return rules and interest crediting in the context of a plan termination).

In addition, the proposed regulations indicate that relief from the anti-cutback rules of Code Section 411(d)(6) may be provided for plan sponsors that reduce an above-market interest crediting rate with respect to benefits that have already accrued, but only to the extent necessary to comply with the market rate of return rules under Code Section 411(b)(5). The IRS anticipates that the proposed regulations will become effective for plan years beginning on or after January 1, 2012. In addition, the IRS is accepting comments to the proposed regulations through January 12, 2011.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

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