



JOINT COMMITTEE ON TAXATION
July 26, 2005
JCX-57-05

**MODIFICATIONS TO THE SENATE FINANCE COMMITTEE
CHAIRMAN'S MARK OF THE
"NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY
GUARANTEE ACT OF 2005"¹**

A. Modifications to Provisions in the Chairman's Mark

1. Modifications to minimum funding rules for single-employer defined benefit pension plans (item III.A.)²

Special rules for plans maintained by financially-weak employers

Under the modification, a plan would not be subject to the special rules for plans maintained by financially-weak employers for a year if, as of the valuation date for the year, the value of plan assets is at least equal to the applicable percentage of the plan's target liability (determined without regard to the at-risk assumptions). The applicable percent of target liability follows the phase-in of the funding rules contained in the Chairman's Mark, and is 93 percent for 2007, 96 percent for 2008, and 100 percent for 2009 and thereafter.

The modification provides that the rules for plans of financially-weak employers do not apply to a multiple employer plan if substantially all of the employers participating in the plan are rural electric or telephone cooperatives (as defined in clauses (i), (ii), (iii), and (iv) of Code section 401(k)(7)(B)) or are cooperative organizations defined in Code section 1381(a) which are owned more than 50 percent by agricultural producers or by cooperatives owned by agricultural producers.

¹ For a description of the Chairman's mark, see Joint Committee on Taxation, *Description of the Chairman's Mark of the "National Employee Savings and Trust Equity Guarantee Act of 2005"* (JCX-56-05), July 22, 2005.

² Item numbers refer to provisions in the Chairman's mark.

Special rules for plans maintained by commercial airlines

The modification provides a special funding rule for single employer defined benefit plans maintained by commercial passenger airlines. The special funding rule applies if the employer elects to have the rule apply and if certain benefit accrual limitations are satisfied. Under the special rule, the minimum required funding contribution for a year is the annual amount necessary to amortize the unfunded liability of the plan, determined as of the first day of the plan year, in equal annual installments over 14 years (or the remainder of the 14-year amortization period). The amount of remaining unfunded liability is determined separately for each year. An election to have the special funding rule apply may not be revoked without the consent of the Secretary. The plan's interest rate is used under the special rule. Airlines that elect the special funding rule could elect to make a one-time change in plan year without approval.

In order for the special rule to apply, the plan generally must provide that accruals are frozen under the plan as of the first plan year to which the rule applies. The freeze on accruals does not apply to amendments that are required as a condition of qualification of the plan.

In addition, the special rule does not apply if, at any time after the date of enactment and before the first plan year for which the election to apply the rule is made, there is an amendment that increases liabilities of the plan due to an increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable. Special rules apply to ensure that the benefit limitations under the proposal are not avoided in the case of successor plans.

If a plan terminates at a time when the special funding rule applies, then the PBGC guarantee provisions are applied as if the plan terminated on the first day of the plan year to which the special rule applied.

These provisions for plans of commercial passenger airlines apply for plan years ending after the date of enactment.

Special rules for a plan maintained by a company engaged primarily in bus service

Under the modification, a special rule applies in the case of a plan that: (1) was not required to pay a variable rate premium for the plan year beginning in 1996; (2) has not, in any plan year beginning after 1995, merged with another plan (other than a plan sponsored by an employer that was within the controlled group of the plan sponsor in 1996); and (3) is sponsored by a company that is engaged primarily in the interurban or interstate passenger bus service. Under the special rule, the minimum funding rules under the proposal are applied by using the mortality tables currently used by the plan. In addition, in determining the minimum required contribution for the plan, the value of plan assets is not reduced by the prefunding balance if, pursuant to a written agreement with the PBGC, the prefunding balance is not available to reduce the minimum required contribution for the plan year.

2. Benefit limitations under single-employer defined benefit pension plans (item III.B.)

The modification eliminates the provision in the Chairman's mark that provides that accruals are frozen when a plan sponsor enters bankruptcy. Thus, under the modification, plans of employers that are in bankruptcy are subject to the same limitations on benefit accruals as other plans. (Under a provision in the Chairman's mark that is retained, the PBGC guarantee is frozen when a plan enters bankruptcy.)

3. Restrictions on funding of nonqualified deferred compensation plan when employer's defined benefit plan is underfunded (item III.F.)

The provision in the Chairman's mark is modified by substituting 80 percent for 60 percent in the definition of restricted period. That is, under the modification, in the case of a financially-weak employer, a restricted period occurs if the funded target liability percentage of the plan is 80 percent or less.

B. Additional Provisions

1. Rules relating to cash balance and other hybrid plans

Present Law

Cash balance and other hybrid plans

A cash balance plan is a defined benefit pension plan with benefits resembling the benefits associated with defined contribution plans. Cash balance plans are sometimes referred to as "hybrid" plans because they combine features of a defined benefit pension plan and a defined contribution plan. Other types of hybrid plans exist as well, such as so-called "pension equity" plans.

Under a cash balance plan, benefits are determined by reference to a hypothetical account balance. An employee's hypothetical account balance is determined by reference to hypothetical annual allocations to the account ("pay credits") (e.g., a certain percentage of the employee's compensation for the year) and hypothetical earnings on the account ("interest credits").

Cash balance plans are generally designed so that, when a participant receives a pay credit for a year of service, the participant also receives the right to future interest on the pay credit, regardless of whether the participant continues employment (referred to as "front-loaded" interest credits). That is, the participant's hypothetical account continues to be credited with interest after the participant stops working for the employer. As a result, if an employee terminates employment and defers distribution to a later date, interest credits will continue to be credited to that employee's hypothetical account.

Cash balance plans and other hybrid plans are subject to the qualification requirements applicable to defined benefit pension plans generally. However, because such plans have features of both defined benefit pension plans and defined contributions plans, questions arise as

to the proper application of the qualification requirements to such plans.³ Issues that commonly arise include: (1) the application of the age discrimination rules; (2) the proper method for determining lump-sum distributions; and (3) the treatment of a conversion to a cash balance plan or other hybrid plan formula.

Age discrimination

Present law prohibits any reduction in the rate of a participant's benefit accrual (or the cessation of accruals) under a defined benefit pension plan because of the attainment of any age. The age discrimination rules do not prohibit all benefit formulas under which a reduction in accruals is correlated with participants' age in some manner. For example, a plan may limit the total amount of benefits, or may limit the years of service or participation considered in determining benefits.

An age discrimination issue has arisen as a result of front-loaded interest credits under cash balance plans because there is a longer time for interest credits to accrue on hypothetical contributions to the account of a younger participant. Several court cases have considered whether front-loaded interest credits under cash balance plans violate the age discrimination rules and have reached inconsistent conclusions.⁴ A similar issue may arise with respect to other types of hybrid plans.

Calculating minimum lump-sum distributions

Defined benefit pension plans, including cash balance plans and other hybrid plans, are required to provide benefits in the form of a life annuity commencing at a participant's normal retirement age. If the plan permits benefits to be paid in certain other forms, such as a lump-sum distribution, the alternative form of benefit cannot be less than the present value of the life annuity payable at normal retirement age, determined using certain statutorily prescribed interest and mortality assumptions.

Most cash balance plans are designed to permit lump-sum distributions of the participant's hypothetical account balance upon termination of employment. As is the case with defined benefit pension plans generally, such a lump-sum amount is required to be the actuarial equivalent to the annuity payable at normal retirement age, determined using the statutory interest and mortality assumptions. A participant's normal retirement benefit under a cash

³ There is little guidance under present law with respect to many of the issues raised by cash balance conversions. In 1999, the IRS imposed a moratorium on determination letters for cash balance conversions pending clarification of applicable legal requirements. Under the moratorium, all determination letter requests regarding converted cash balance plans are sent to the National Office for review; however, the National Office is not currently acting on these plans.

⁴ *Tootle v. ARINC Inc.*, 2004 U.S. Dist. LEXIS 10629 (June 10, 2004); *Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003); *Eaton v. Onan*, 117 F. Supp. 2d 812 (S.D. Ind. 2000). In addition, proposed Treasury regulations issued in December 2002 provided rules under which cash balance plans could provide front-loaded interest credits without violating the age discrimination rules. However, the Treasury Department announced the withdrawal of the regulations in June 2004.

balance plan is determined by projecting the participant's hypothetical account balance to normal retirement age by crediting future interest credits, the right to which has already accrued, and converting the projected account balance to an actuarially equivalent life annuity payable at normal retirement age, using the interest and mortality assumptions specified in the plan.

A difference in the rate of interest credits provided under the plan, which is used to project the account balance forward to normal retirement age, and the statutory rate used to determine the lump-sum value (i.e., present value) of the accrued benefit will cause a discrepancy between the value of the minimum lump-sum and the employee's hypothetical account balance. In particular, if the plan's interest crediting rate is higher than the statutory interest rate, then the resulting lump-sum amount will be greater than the hypothetical account balance.⁵

Protection of accrued benefits when a plan is amended

In general, an amendment of a qualified retirement plan may not reduce benefits that have already accrued (the "anticutback rule"). For this purpose, an amendment is treated as reducing accrued benefits if it has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy or of eliminating an optional form of benefit. Several approaches may be used to comply with the anticutback rule, including wearaway and no-wearaway approaches.

Under a wearaway approach, a participant's accrued benefit after a plan amendment is determined as the greater of: (1) the participant's accrued benefit before the amendment ("preamendment" accrued benefit); and (2) the benefit determined by applying the new benefit formula to all the participant's years of service, both before and after the amendment. Under a wearaway approach, if a participant's preamendment accrued benefit is greater than the benefit provided under the new formula, the participant may have a period (a wearaway period) during which the participant does not accrue any additional benefits.

Under a no-wearaway approach, a participant's benefit after a plan amendment is determined as the sum of: (1) the participant's preamendment accrued benefit; and (2) the accrued benefit that results from applying the new formula with respect to years of service after the plan amendment. Under this approach, participants earn additional benefits under the new plan formula immediately.

In addition to wearaway and no-wearaway approaches, a plan amendment may include a grandfather provision under which the benefit formula that applied before the amendment continues to apply to the participants in the plan before the amendment if it provides a greater benefit than the new formula or under which such participants may choose between the old and new formulas. Alternatively, a plan amendment may provide a grandfather provision for older and longer-service participants.

⁵ This result is sometimes referred to as "whipsaw."

Description of Proposal

In general

The proposal provides rules that apply on a prospective basis to address issues surrounding cash balance plans and other similar hybrid plans with respect to: (1) application of the prohibition on age discrimination; (2) determination of minimum lump-sum benefits; and (3) requirements for conversions to a cash balance plan design. In addition, the proposal includes interest credit and vesting requirements that apply to cash balance plans and other similar hybrid plans on a prospective basis.

Age discrimination

Under the proposal, a cash balance plan or other similar hybrid plan does not violate the prohibition on age discrimination merely because, for younger employees, front-loaded interest credits apply over a longer period than for older employees, provided that the rate of pay credit or interest credit under the plan does not decrease because of the participant's attainment of any age.

Lump-sum distributions

Under the proposal, a cash balance plan or other similar hybrid plan may provide that the lump-sum benefit payable to a participant is the balance of the participant's hypothetical account balance, provided that the plan does not provide for interest credits at a rate that exceeds a market rate of return. The Secretary of the Treasury is authorized to issue regulations as to what constitutes a market rate of return for this purpose. It is intended that interest credits will not be treated as provided at a rate that exceeds a market rate of return merely because a plan provides interest credits at a rate required under the proposal as discussed below (i.e., not less than the applicable Federal mid-term interest rate).

Conversions

Under the proposal, if a defined benefit plan is converted to a cash balance plan or other similar hybrid plan pursuant to a plan amendment, one of three transition requirements must be met:

1. The plan must not provide for a wearaway approach with respect to accrued benefits or any subsidized optional form of benefit (such as a subsidized early retirement benefit). In addition, either (1) for at least five years after the conversion, the plan provides all participants who were covered by the plan before the conversion with the greater of accruals under the old formula or under the new formula; or (2) in the case of participants who, at the time of the conversion, were at least age 40 and had combined age and service of at least 55 (or such lower age and combined age and service as provided under the plan), after the conversion, the plan provides such participants with (a) the greater of the benefits determined under the old formula or under the new formula or (b) the right to elect either benefits determined under the old formula or under the new formula.

2. After the conversion, the plan provides all participants who were covered by the plan at the time of the conversion with (1) the greater of the benefits determined under the old formula or under the new formula or (2) the right to elect either benefits determined under the old formula or under the new formula.
3. The plan provides additional credits or additional opening account balances in amounts substantially equivalent to the benefits that would be provided in order to satisfy one of the two preceding requirements, as determined under regulations issued by the Secretary of Treasury. It is intended that additional amounts necessary to satisfy this requirement shall not cause the plan to violate the nondiscrimination rules or the limits on benefits, and that contributions required to provide such additional amounts are deductible.

Vesting and interest credit requirements

Under the proposal, a cash balance plan or other similar hybrid plan generally must provide interest credits at a rate not less than the applicable Federal mid-term interest rate (i.e., the interest rate based on Treasury obligations with a term of more than three and not more than nine years). In addition, the Secretary of Treasury is directed to issue regulations that provide alternatives to the use of the applicable Federal mid-term interest rate in appropriate circumstances.⁶

Under the proposal, benefits under a cash balance plan or other similar hybrid plan must fully vest after three years of service.

Definition of hybrid plan

Under the proposal, a cash balance is defined as a defined benefit plan under which the accrued benefit is based on the balance of a hypothetical account determined by reference to annual pay credits and interest credits. In addition, the Secretary of the Treasury is directed to define by regulations other similar hybrid plans to which the proposal applies.

Effective Date

The proposals relating to the age discrimination rules and minimum lump-sum distributions are effective July 26, 2005. The proposal relating to conversions is effective for conversions made pursuant to a plan amendment adopted and effective after July 26, 2005. In addition, in the case of a conversion pursuant to a plan amendment adopted before July 26, 2005, but effective after that date, the employer may elect to apply the proposal to the conversion. The proposals relating to interest credits and vesting are effective for plan years beginning after December 31, 2006. No inference is intended to be drawn from the proposal as to the treatment of cash balance plans (and other hybrid plans) or conversions under present law.

⁶ For example, in the case of pension equity plans, the interest credit requirement may be applied on the basis of a fixed rate of return of three percent, which may be reflected in the benefit formula using age groupings of up to five years.

2. Defined benefit plans maintained by tribal governments

Present Law

Under present law, in some cases governmental plans are subject to different rules than other qualified plans. For example, governmental plans generally are not subject to the same nondiscrimination rules as other plans and the minimum funding rules do not apply to such plans.

Description of Proposal

The proposal provides that, in the case of defined benefit plans, the term “governmental plan” includes a plan established or maintained for its employees by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency instrumentality (or subdivision) of an Indian tribal government, or an entity established under Federal, State, or tribal law which is wholly owned or controlled by any of the foregoing. No inference is intended that the proposal is not present law or that defined contributions plans maintained by an employer described in the proposal are not governmental plans.

Effective Date

The proposal is effective on the date of enactment.

3. Treatment of plan of certain nonprofit organization as a governmental plan

Present Law

Under present law, in some cases governmental plans are subject to different rules than other qualified plans. For example, governmental plans generally are not subject to the same nondiscrimination rules as other plans and the minimum funding rules do not apply to such plans.

Description of Proposal

The modification provides that a defined benefit plan of a nonprofit organization is treated as a governmental plan if the organization was: (1) incorporated on September 16, 1998, under a State nonprofit corporation statute; and (2) organized for the express purpose of supporting the missions and goals of a public corporation which was (a) created by a State statute effective on July 1, 1995, (b) is a governmental entity under State law, and (c) is a member of the nonprofit corporation.

Effective Date

The proposal is effective on the date of enactment.