Hybrid Pension Plans

Current Law With Regard to Hybrid Pension Plans.

There is no current law requirement to establish or maintain a defined benefit pension plan as a condition of being in business. Sponsors of existing plans may freeze or terminate them if they choose to do so. There is no requirement for a business that sponsors a defined benefit plan to have a traditional (i.e. final average pay) plan.

A hybrid pension plan, cash balance plan or a pension equity (PEP) plan is a defined benefit plan with features that resemble a defined contribution plan. Under a cash balance plan, benefits are determined with regard to a hypothetical individual account balance. The employee's account balance is determined by reference to hypothetical annual allocations to the account ("pay credits" that consist of a specified percentage of the employee's pay per year) plus hypothetical earnings on the account ("interest credits"). These plans are designed so that, when a participant receives a pay credit for a year of service, the individual also receives a right to future interest on the pay credit, regardless of whether the participant continues employment. While this has been described as being a "front-loaded" plan design, that term is confusing. The design is more appropriately described as "even-loaded" because it provides the same hypothetical pay and interest credits per year of service for each year for each participant.

Hybrid plans are subject to the requirements for defined benefit plans in ERISA and the Internal Revenue Code.

Questions have arisen regarding conversions to a hybrid design from a traditional defined benefit design, the method for determining lump sum distributions from the plans and the application of age discrimination to the hybrid plan design.

Hybrid plans have been criticized because conversions are often accompanied by changes that reduce accruals of normal retirement benefits prospectively, reduce or eliminate early retirement subsidies prospectively and wear-away early retirement subsidies. These actions are not unique to hybrid plans, or to conversions to a hybrid design however. Both traditional defined benefit plans and multiemployer plans also engage in these practices.

Conversions.

The formula used to calculate benefits for a traditional defined benefit plan provides richest benefit only to individuals who remain with the same employer for a very long period of time. The richness of the benefit is contingent upon the rate of accrual (or, in the case of a flat-dollar plan, the dollar amount) and whether the plan contains an early retirement subsidy, how generous it is and whether or not the participant worked past earliest age at which he or she could retire or changed jobs prior to becoming eligible for the full value of the early retirement subsidy.

By contrast, under hybrid plans, workers earn pay and interest credits more equitably during the course of job tenure. Hybrid plan conversions often eliminate an early retirement benefit, but only prospectively. When this occurs, long-service workers may not obtain -- in the future -- the degree of early retirement benefit that would have been generated had additional subsidies continued to accrue. Under current law, a plan amendment may not eliminate an accrued benefit. Current law rules in ERISA and the IRC protect benefits earned at the time of the conversion. Plans must also continue to credit service for purposes of qualifying a participant for early retirement subsidies applicable to that person's benefit earned under the plan prior to the adoption of the amendment.

Lump Sum Calculations.

Defined benefit plans, including hybrid plans, must offer benefit distributions in the form of a life annuity commencing at the participant's normal retirement age. If the plan permits payment of benefits in another form, such as a lump sum, the alternative form of benefit cannot be less than the present value of the life annuity payable at normal retirement age.

Most hybrid plans are designed to permit payment of benefits in the form of a lump sum distribution. The plan that pays a lump sum must pay an amount equal to the actuarial equivalent of the annuity payable at normal retirement age. Under regulatory guidance, this amount is generally measured by projecting the participant's hypothetical account balance plus interest credits forward to normal retirement age and then discounting it back using the 30-year Treasury bond rate. Unless the interest credits to the hypothetical account balance are equal to the 30-year Treasury bond rate, this project forward/discount back methodology requires plan sponsors to pay an amount greater than the account balance. This result is referred to as a "whipsaw".

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 years of service considered in determining benefits.

An age discrimination issue has arisen with regard to the cash balance design because there is a longer time for interest credits to accrue on contributions to the account of a younger participant than to the account of an older participant. While interest credits that are equal for workers of all ages and that compound over time is the standard cash balance design, a single federal district court has held that this design violates the age discrimination rules (Cooper v. IBM Personal Pension Plan (S.D. Ill. 2003)). The legal theory adopted by this court also deems pension equity plans to be age discriminatory and would appear to jeopardize other defined benefit designs that have a time value of money/compound interest feature. This would, in theory, also condemn contributory defined benefit plans maintained by many state and local governments. While all other courts have rejected the Cooper analysis, there is significant legal uncertainty as a result of the Cooper decision.

Finance, Education and the Workforce and The Administration.

The Finance Committee bill provides rules that apply, on a prospective basis, to: (1) validate cash balance and similar hybrid plan designs under the age discrimination rules (presuming pay and interest credits do not decrease on account of age), (2) end the whipsaw effect for calculation of cash balance plan lump sums (i.e., allowing plans to pay the account balance) provided that the plan does not provide for interest credits that exceed a market rate of return, and (3) impose extensive new requirements for future hybrid plan conversions. Future hybrid plan conversions would have to satisfy one of three requirements:

(1) prohibit wear-away of normal and early retirement benefits and offer specified transition benefits (benefits for all participants at least as great as under the prior formula for five years or choice or "greater of" for those at least age 40 whose age and service combined is at least 55), (2) provide to all participants the choice between the prior and new formula or the greater of the benefits under the prior or new formulas, or (3) provide additional pay credits or opening account balance amounts substantially equivalent to the benefits under the first and second requirements. The Finance Committee bill also imposes new interest crediting and vesting requirements on hybrid plans.

The House bill addresses the age discrimination design issues surrounding hybrid plans by clarifying the general age discrimination rule for defined benefit plans rather than stating a hybrid plan-specific rule. Specifically, the House bill clarifies -- on a prospective basis -- that defined benefit plans are not age discriminatory if a participant's entire accrued benefit, determined under the plan formula as set forth in the plan documents, would be equal to or greater than that of any similarly situated younger individual. Chairman Boehner has expressed a desire that this clarification apply with respect to current law as well as prospectively and has introduced stand-alone legislation (H.R. 2831) to achieve this objective. The House bill is also intended to clarify that inclusion of some or all of the value of early retirement subsidies in cash balance opening accounts is permissible under the age discrimination rules. The House bill's approach to the whipsaw issue is essentially the same as that taken in the Finance Committee bill.

The Administration's proposal is generally similar to the Finance Committee bill but does not impose new minimum interest crediting and vesting requirements on hybrid plans. There are some minor differences between the requirements for future conversions under the Finance Committee bill and under the Administration's proposal.

The HELP Substitute.

The HELP Substitute clarifies the law with regard to hybrid plans retroactively and prospectively and states that the hybrid pension plan design does not violate the prohibition on age discrimination because the period of time over which interest credits may be made to a participant's account is longer for a younger participant. In addition, the pay and interest credits for any participant may not decrease by the attainment of any age.

Hybrid Plan Rule Retroactively: A series of safe harbors are available for plan sponsors who wish to satisfy the rule.

Rule A prohibits the "wear away" of both normal and early retirement benefits and requires the plan sponsor to have provided one of the following:

* Greater of the old or the new benefits for all participants for 5 years; OR

* Greater of the old or the new benefits at retirement for the entire group of participants who are age 40 and whose age and service equal 65, OR

* Informed choice at conversion for the entire group of participants who are age 40 and whose age and service equals 65, OR

* Company received IRS determination letter deeming the plan in compliance.

Rule B prohibits wear away of normal retirement benefits and requires plan sponsors to have provided one of the following:

* Grandfathering of all employees over age 40, OR

* Greater of the old or the new benefits at retirement for the group of participants who are age 40 and whose age and service equal 60, OR

* Informed choice at conversion for the group of participants who are age 40 and whose age and service equal 60, OR

* Conversion was product of collective bargaining, OR

* Conversion resulted from a career-average pay plan.

Rule C could be satisfied if the plan sponsor offered choice for all participants through providing examples, estimates of the relative value, comparisons or through projections of benefits.

Plan sponsors may provide additional pay or interest credits to satisfy any of these options.

The language does not change the treatment of early retirement subsidies under current law in that it is the nature of these benefits to decline in value on account of age.

If a plan opts to take advantage of a safe harbor, it has three years from the date on which IRS regulations become final to locate their participants and "top up" their account, if necessary.

A litigation carve out applies to actions filed before August 1, 2005. The language further protects plans from application of the "backloading" rules because they provided transition, pay and interest credits and from the adverse nondiscrimination rules in cases where they grandfathered participants, provided choice, offered the greater of the old or new benefits or provided transition credits. Plans that put part or all of an early retirement subsidy into a participant's opening account balance shall not violate benefit accrual rules, nor shall they be found to be in violation of age discrimination rules. The Treasury Department is instructed to develop rules with regard to conversions for groups of employees acquired by reason of a merger, acquisition, or a similar transaction within 12 months of the date of enactment.

Hybrid Plan Rule Prospectively: The prospective rule follows the Senate Finance Committee.