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New Developments in Cash Balance and Other Hybrid Plans: The Pension Protection Act and the *Cooper* Case

The newly-enacted Pension Protection Act of 2006 (the "Act") includes significant prospective relief for sponsors of cash balance and other "hybrid" plans. In addition, a week prior to the passage of the Act, the Seventh Circuit issued a decision in *Cooper v. IBM Personal Pension Plan* regarding age discrimination in cash balance plans. Taken together, the Act and the *Cooper* case resolve many areas of confusion and provide significant favorable guidance to employers in the design and implementation of "hybrid" plans. The Act also provides a new hybrid plan alternative: the "DB(k)" plan.

In recent weeks, the Benefits Law Group has issued three News Alerts summarizing the impact of the Act on defined contribution plans (particularly the Act's automatic enrollment and fiduciary provisions), as well as the numerous changes in the funding of defined benefit plans.

This News Alert, the final Alert in this series, addresses the provisions of the Act that resolve previously open issues in hybrid plan design, including age discrimination, "wear-away" and "whipsaw" problems. This Alert also discusses the basics of the *Cooper* decision in conjunction with the changes in the Act, and outlines the structure of the new DB(k) alternative.

What is a "Hybrid" Plan?

Cash balance and pension equity plans exhibit features of both defined benefit and defined contribution plans, therefore they are often referred to as "hybrid" plans. Because these plans look similar to a defined contribution profit sharing or money purchase plan where the normal form of distribution is a lump sum, the value of these plans is generally easier to communicate to employees than a traditional defined benefit plan where the normal form of distribution is an annuity.

A cash balance plan is a defined benefit plan with the look and feel of a defined contribution arrangement. Since it is a defined benefit plan, a cash balance plan does not allocate contributions to individual accounts. Rather, like any other defined benefit plan, the employer must provide the benefits promised under a cash balance plan regardless of the performance of the plan's underlying assets. However, participants typically have a "notional account" that describes the benefit to be paid at retirement similar to an account balance plan. A common cash balance formula calls for a contribution called a "pay credit," which is then credited with interest at some specified rate. Under a cash balance formula, a participant accrues relatively greater benefits earlier in his or her career, and because benefits are more often paid in lump sums, benefits are considerably more portable.

Another popular hybrid plan is referred to as a "pension equity plan." Under a pension equity plan, a participant's lump-sum benefit equals a percentage of his or her final average pay multiplied by the number of years of credited service.

The Hybrid Plan Age Discrimination Problem—and Solution

For the last decade, hybrid plans were challenged as being intrinsically discriminatory under the Age Discrimination in Employment Act, since the interest-crediting feature of these plans resulted in a higher value of an annual accrual for a younger employee than for an older employee (because the younger employee has more years until retirement). The Act makes it clear that hybrid plans are not age-discriminatory so long as the annual credit itself does not discriminate on the basis of age. In other words, if the *method* of crediting interest is not discriminatory, the ultimate *result* will not be challenged.

Although the Act pointedly refused to consider the discrimination aspects of hybrid plans implemented prior to June 29, 2005, in *Cooper v. IBM Personal Pension Plan,* the U.S. Court of Appeals for the Seventh Circuit affirmed that the basic cash balance plan structure established prior to this date is legal. The circuit court specifically found that IBM's cash balance plan treated all employees equitably, as the plan did not stop making allocations or accruals to the plan, nor did it change the *rate* at which benefits accrued on account of age. In the view of the appellate court, the district court erred by treating the "time value of money" as age discrimination. The appellate court held that the term "benefit accrual" should be understood to mean what the employer imputes to the account, noting that the effect of interest is not treated as age discrimination for a defined contribution plan and should not be treated as age discrimination for a defined benefit plan.

Although the Seventh Circuit recognized that the older workers had a legitimate complaint since they were worse off under a cash balance plan as compared to a traditional years-of-service-times-final-salary plan, the court concluded that "removing a feature that gave extra benefits to the old differs from discriminating against them."

Thus, both the Act and the *Cooper* case provide comfort to an employer that a hybrid plan is not and will not in the future be considered discriminatory based solely on its inherent design.

Defined Benefit Plan Conversions and the Elimination of Benefit "Wear-Away"

As noted above, the Act specifically declines to address conversions from a traditional defined benefit formula to a hybrid plan formula that occurred prior to June 29, 2005. For conversions occurring after June 29, 2005, however, the Act prohibits the "wear-away" of pre-conversion accrued benefits.

In the past, there were two approaches to benefit calculations upon the conversion of a traditional plan to a hybrid plan. One possible formula was cumulative, adding the old benefit based on the pre-conversion formula (taking into account service up to the date of the conversion) to the benefit under the new cash balance plan (taking into account only post-conversion service). Another way to accomplish the conversion was to use an offset formula; that is, using the frozen benefit under the old plan (taking into account service up to the date of conversion) and comparing it to the new benefit formula (based on service *both before and after* the date of conversion). Under the latter formula, where a participant had a significant pre-conversion accrued benefit, he or she might not have accrued anything under the new formula for a significant period of time, *i.e.*, until the excess benefit under the old formula "wears away."

Under the Act, a participant's benefit following the conversion must equal the value of the benefit prior to the conversion plus the benefit earned after the conversion, in essence prohibiting the use of the offset formula for future conversions.

Resolution of "Whipsaw" Concerns

The term "whipsaw" relates to the manner in which lump-sum account balances are paid under defined benefit plans, including hybrid plans. While the lump sum under a defined contribution plan is the then-current value of the account, the lump sum under a cash balance plan is determined by projecting the benefit forward to retirement based on the plan's interest crediting rate, and then discounting back to the distribution date using an interest rate prescribed by law. If the plan crediting rate is higher than the discount rate, then the lump-sum benefit would be higher than the balance in the participant's notional cash balance account, creating a "whipsaw" effect for the employer.

The Act provides that, for distributions made after the effective date of the Act, a participant's lump sum distribution can equal the hypothetical or notional cash balance account, thereby resolving the whipsaw issue. This reverses prior case law in which several courts had concluded, based on IRS regulations, that a distribution could not be less than the present value of the participant's projected annuity at the plan's normal retirement age.

Interest Rate and Vesting for Hybrid Plans

Interest Rate. The Act provides that the interest rate used by the plan for present value and benefit calculations may not exceed a market rate, which can equal the greater of a fixed or a variable rate and may also provide a minimum guaranteed rate of return. This provision eliminates a potential problem in hybrid plan design that occurred where the plan credited interest to a participant's account at a rate not sufficiently tied to market factors.

Three Year Vesting Required. The Act mandates that all benefits accrued under a hybrid plan must be vested within three years. This provision is generally effective January 1, 2008.

DB(k) Plans

The Act outlines the possibility of adopting a different hybrid plan for employers with fewer than 500 employees beginning in 2010. The "DB(k)" plan would be a true "hybrid" – although the defined benefit component would be subject to the defined benefit rules, the 401(k) component would be subject to the defined contribution rules and only one annual report and one trust would be required. The defined benefit component of the plan must be either a 1% of final average pay formula for up to 20 years of service *or* a cash balance formula that increases with the participant's age (and subject to the rules discussed above). This portion of the plan would require three year vesting. The 401(k) portion of the plan would have to include automatic enrollment at a 4% rate and provide for a fully vested match of 50% on the first 4% deferred. A DB(k) would be exempt from the current top heavy rules and would be deemed to satisfy the ADP/ACP nondiscrimination rules.

For additional information regarding hybrid plans or the Pension Protection Act, contact any member of the Holland & Hart Benefits Law Group.

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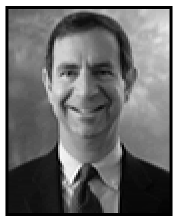

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