

Employee Benefits Law Update

November 2006

Published by the Hanson Bridgett Employee Benefits Law Practice Group

415.777.3200

Renewed Vigor for Hybrid Plans After Enactment of Pension Protection Act *By Connie Hiatt*

A jolt of renewed interest has been given to cash balance plans and other hybrid retirement plans due to a recent court decision and the Pension Protection Act (“PPA”). Over the past decade, traditional defined benefit plans have been increasingly viewed as undesirable by many employers. This declining desirability is due to a variety of reasons—including volatility of funding, declining investment returns, which pushes the need for increased employer contributions, and complex regulations and accounting disclosure requirements. As a result, more and more employers have become interested in hybrid plans, predominantly cash balance plans, as possible retirement vehicles with less of the perceived negative attributes of typical defined benefit plans. A wave of highly publicized lawsuits alleging age discrimination in connection with conversion of traditional defined benefit plans to cash balance plans introduced questions about employers’ ability to use such plans. Additionally, the IRS began holding up determination letters for plans that had been converted from traditional defined benefit plans to cash balance or other types of hybrid plans.

In August, 2006, the court of appeals for the Seventh Circuit overturned a lower court and held that the IBM cash balance plan was permissible under ERISA and did not discriminate against older workers. The court noted that the use of a uniform formula for all employees did not violate the age discrimination law. Although the decision may be appealed (and may not be following in other circuits), it was a welcome ruling for those who converted to cash balance plans before PPA.

Congress similarly offered relief in the recent PPA. PPA provides that cash balance plans do not violate age discrimination law if certain rules are followed. PPA provides relief for a defined benefit plan under which the accrued benefit is calculated as the balance credited to a hypothetical account or as an accumulated percentage of the participant’s final average compensation. I.R.C. § 411(a)(13), as amended by PPA.

PPA further provides that such a plan must ensure that as of any date, a participant’s accrued benefits must be at least as great as that of any other similarly situated younger individual who is a participant in the plan. Individuals will be considered similarly situated if they are identical in every respect except age (ignoring early retirement subsidies). Additionally, PPA in an effort to limit benefits favoring younger employees, does not permit excessively generous benefits through the use of interest credits. PPA limits interest credits up to a rate not greater than the market rate of return. The IRS is directed to issue guidance on what is a market rate of return and what minimum level of interest rate may be used. PPA also requires that all participants in hybrid plan must be 100% vested after three years of service.

PPA restricts the ability to use what was conventionally termed “wear away” provisions when converting a traditional defined benefit plan to a hybrid plan. After a conversion of a traditional defined benefit plan, a participant’s accrued benefit must at least equal the sum of the participant’s accrued benefit for years of service before the date of conversion, determined under pre-conversion traditional defined benefit plan, plus the participant’s accrued benefit for years of service after the date of conversion determined under the new converted hybrid plan.

Additionally, the Code now protects sponsors from what is commonly referred to as the “whipsaw” effect. For purposes of calculating lump sum and other additional optional forms of payment, a plan can treat the present value of a participant’s accrued benefit as being equal to the participant’s hypothetical account balance or an accumulated percentage of the participant’s final average compensation. In other words, a plan no longer needs to project a participant’s benefits forward to normal retirement age using the plan’s interest rate and then discount back using the Code required interest rates.

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RUDY-LLP

For more information, please contact:

Connie Hiatt

415-995-5099
chiatt@hansonbridgett.com

Bob Blum

415-995-5830
rblum@hansonbridgett.com

Edward Frueh

415-995-5890
efrueh@hansonbridgett.com

Marcus Wu

415-995-5829
mwu@hansonbridgett.com

Carol Malenka Collins

415-995-5128
ccollins@hansonbridgett.com

Anne Hydorn

415-995-5893
ahydorn@hansonbridgett.com

www.hansonbridgett.com

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