



AMERICAN BENEFITS
COUNCIL

SUMMARY OF NOTICE 2007-6
GUIDANCE ON CASH BALANCE AND
OTHER HYBRID DEFINED BENEFIT PLANS

The Pension Protection Act of 2006 (PPA) contains provisions relating to cash balance and other hybrid defined benefit plans. The U.S. Treasury (Treasury) and the Internal Revenue Service (IRS) issued interim guidance on December 21, 2006, in the form of Notice 2007-6 to help interpret those provisions.

The following is a summary of some of the key points in the guidance.

Definition of Hybrid Plan. The Notice defines hybrid plans as either a lump-sum based plan or a plan that has a similar effect. A lump-sum based plan is a plan under the terms of which the accumulated benefit is expressed as a balance of a hypothetical account or as the current value of the accumulated percentage of the participant's final average compensation, and includes a plan where the accrued benefit is calculated as the actuarial equivalent of the hypothetical account balance or accumulated percentage. Thus, a hybrid plan can define the participant's accrued benefit as an annuity at normal retirement age that is actuarially equivalent to the account balance or value. A plan that has similar effect includes a plan that provides that a participant's accrued benefit (payable at normal retirement age) includes automatic periodic increases through normal retirement age that result in the payment of a larger amount at normal retirement age to a similarly situated participant that is younger (includes indexing of accrued benefits). Post-retirement adjustments and variable annuity plans that have an assumed interest rate used for purposes of adjustment of amounts payable to a participant that is at least five percent are not treated as similar.

Market Rate of Return. The PPA requires that any hybrid plan interest crediting rate (or its equivalent) cannot exceed a "market rate of return". Notice 2007-6 indicates Treasury and the IRS expect to issue further guidance during 2007 that is expected to include some 411(d)(6) relief for a post-August 17, 2006, amendment that changes the plan's interest crediting rate. Pending further guidance, the Notice provides a safe harbor for determining the market rate if plans use (1) long-term investment grade corporate bond rate (used for funding purposes for plan years beginning prior to January 1, 2008), (2) the third segment rate of the new yield curve (bonds maturing in excess of 20 years), (3) the 30-year Treasury rate, or (4) the sum of any of the standard indices and the associated margin for that index as described in part IV of Notice 96-8 (which is the notice that describes the old "whipsaw" calculation).

Conversion Requirements. The Pension Protection Act requires plans converting from a traditional defined benefit plan to a statutory hybrid plan to meet certain requirements including that the participants receive benefits based on the old formula until the date of conversion and benefits based on the new formula after that date (no “wearaway”). The Notice interprets that requirement by stating the accrued benefit of the participant under the terms of the plan in effect after the conversion amendment cannot be less than the sum of (1) the participant’s accrued benefit for years of service before the effective date of the conversion amendment, determined under the old plan terms, and (2) the participant’s accrued benefit for years of service after the effective date of the amendment, determined under the new plan terms. The benefit must include a credit for the amount of any early retirement benefit or retirement-type subsidy under the old plan terms for the plan year in which the participant retires if, as of such time, the participant has met the age, years of service, and other requirements under the plan (based on the annuity starting date). The requirements apply to conversion amendments adopted after, and taking effect after June 29, 2005.

Mergers. The Notice indicates Treasury and the IRS intend to issue regulations on conversions relating to mergers and acquisitions no later than August 17, 2007. Pending further guidance, the benefit of each participant under the plan, amended, cannot be less than the sum of (1) the participant’s section 411(d)(6) protected benefit with respect to service before the effective date of the conversion amendment, determined under the old plan terms, and (2) the participant’s section 411(d)(6) protected benefit with respect to service on and after the effective date of the conversion amendment, determined under the new plan terms (each of these benefits must be determined in the same manner they would be if they were provided under separate, independent plans including no benefit offsets).

Determination Letters. The IRS announced in the notice that it is beginning to process determination letters previously subject to the hybrid plan moratorium on determination letters and indicated that certain rules will be applied for purposes of processing the moratorium plans. The Notice makes clear that frontloaded interest credits, a typical design of cash balance plans, will not cause the IRS to “caveat” the determination letter with respect to the age discrimination issue (and the Notice states earlier that the IRS consulted the Equal Employment Opportunity Commission or EEOC before issuing guidance). The Notice also indicates backloading rules will continue to apply (3-percent method, 133 and 1/3 percent rule, and fractional rule of Code Section 411(b)(1)). In addition, the Notice distinguishes between conversions before June 30, 2005, and after June 29, 2005. For the earlier conversions, the Notice makes clear that the determination letter will not consider (and may not be relied upon with respect to) whether the plan meets new statutory requirements, including the

effects of any wearaway. For the latter conversions, the conversion must meet the new PPA requirements for conversions.

In addition, the Notice states that until Treasury and the IRS issue further guidance under new Code Section 411(a)(13)(A) (which permits the hybrid plan to determine the accrued value as an amount expressed as the balance in a hypothetical account or as an accumulated percentage of the participant's final average compensation), the IRS will not process a moratorium plan that does not satisfy the requirements of Notice 96-8 with respect to distributions made before August 18, 2006. In addition, the Notice indicates that the PBGC has informed the IRS that a terminating plan with a termination date that is prior to August 18, 2006, cannot apply 411(a)(13)(A) in determining benefit liabilities with respect to any distributions made by the terminating plan.

204(h) Notice. The guidance clearly indicates that the 204(h) notice must be provided at least 30 days before an amendment is effective that could significantly reduce the rate of future benefit accruals even if the amendment is retroactively effective (such an amendment might be necessary to address the whipsaw interest crediting issue). Although this requirement seems strange, it appears they expect plans to give the 30-day advance notice before an operational change is made even if the actual amendment is not done for some time.

Requested Comments. The Notice also requests comments (by April 16, 2007,) on a number of issues for the upcoming regulations (which they indicate will not address all outstanding issues) including:

- Identification of when two or more amendments, or the coordination of two or more defined benefit plans, have the effect of a conversion to a hybrid plan.
- Definition of market rate of return including
 - The impact of the minimum rate of return rules in the second sentence of new Code Section 411(b)(5)(B)(i)(I);
 - The impact of the preservation of capital rule in new Code Section 411(b)(5)(B)(i)(II); and
 - The application of 411(d)(6) to an amendment to the interest crediting rate and when that relief should apply.
- Application of special rules when only certain participants' accrued benefit, or only a portion of a participant's accrued benefit, is determined by reference to a hypothetical account, etc., including offset plans.
- Application of requirements to Pension Equity Plans (PEPs)
- Indexing