

**SUMMARY OF 2/2/04 TREASURY BRIEFING ON BUSH ADMINISTRATION
LEGISLATIVE RECOMMENDATIONS REGARDING HYBRID PENSION PLANS
Prepared by the Benefits Group of Davis and Harman LLP**

Background

This morning, the Treasury Department held a briefing on the Bush Administration's legislative recommendations regarding hybrid plans that are included in the Administration's Fiscal Year 2005 budget submission to Congress. The briefing was conducted by Greg Jenner, Deputy Assistant Secretary for Tax Policy, and Michael Doran, Deputy Benefits Tax Counsel. In attendance were representatives from AARP, American Benefits Council, American Society of Pension Actuaries, Business Roundtable, Coalition to Preserve the Defined Benefit System, ERISA Industry Committee, National Association of Manufacturers, Pension Rights Center, and U.S. Chamber of Commerce.

Overview of Treasury Proposal

The Treasury legislative proposal is divided into three parts: (1) transition requirements for employers converting from traditional defined benefit plans to cash balance plans, (2) clarification of the status of hybrid designs under the age discrimination statutes, and (3) resolution of the so-called whipsaw issue, which under a number of court cases has required employers to pay departing employees higher benefits than the balances in their cash balance accounts. The proposal does not define what a cash balance plan is but the Treasury recognizes this needs to be part of any ultimate legislation. All three elements of the proposal would be prospective only (as of the date of enactment of legislation) and there would be no inference as to what the law was in the past on any of the three issues. Treasury recognizes that this proposal offers no specific relief for the employers that have determination letters currently pending at the IRS (or other employers looking to clarify the legality of their past conversions or past designs). The proposal would amend the Internal Revenue Code as well as the parallel provisions of ERISA and the Age Discrimination in Employment Act but the sole remedy envisioned for the new conversion requirements would be the excise tax regime discussed below. Treasury would not comment as to the views of the Department of Labor or Equal Employment Opportunity Commission on these proposals nor to how Treasury intends to advance these proposals on Capitol Hill.

Conversion Requirements

Treasury's proposal would require that employers instituting a cash balance conversion provide benefits under the cash balance plan, for a period of five years after the conversion, that are as least as generous as the benefits that employees would have earned had the traditional defined benefit formula continued in existence. (Benefit improvements to other plans, such as defined contribution plans, could not be taken into account in satisfying this requirement.) This 5-year hold harmless protection would apply to all employees experiencing the conversion to the cash balance design. In addition, Treasury would ban the wear-away of both normal retirement benefits and early retirement benefits. The wear-away ban would not apply outside the conversion to hybrid plan context.

In determining protection of the normal retirement benefit, the employer would use the 417(e) rate in valuing the normal retirement benefit. (The proposal does not speak to the issue of what interest rate should be used in testing protection of the early retirement benefit.) Not only would the benefits as of the date of the conversion be protected from wear-away but also the benefits as of the end of the 5-year hold harmless provision. The value of early retirement benefits need not be included in the cash balance account (although the proposal would make clear that employers could do this without running afoul of the age discrimination rules – see below) but rather could be held as a contingent or "pop up" benefit to be paid to the employee if he or she left the company at a time when the early retirement benefit still had value. If a company chose to provide choice or a grandfather in the prior traditional plan to a group of employees, the 5-year hold harmless requirement would be satisfied but only with

James Delaplane, The Benefits Group of Davis & Harman LLP

respect to that group of employees. Any employees left out of the choice or grandfathering group would need to be provided with the 5-year hold harmless protection. Treasury recognized the need for provisions to protect against avoidance of the new conversion requirements by employers that would seek to freeze their plan and then start up a new hybrid, but such protections are not currently contained in the proposal.

The 5-year hold harmless requirement would be enforced through an excise tax mechanism. Employers that did not comply with the 5-year requirement would face a 100% excise tax equal to the difference between the benefits actually provided to employees and the benefits that would have been paid if the prior formula had continued for five years. Recognizing that certain employers may convert to a less generous hybrid design due to financial constraints, there would be a cap on the excise tax of the greater of any surplus in the defined benefit plan at the time of conversion or the taxable income of the corporation sponsoring the plan. While not detailed in the proposal, Treasury anticipates development of a mechanism for measuring surplus and corporate taxable income so as to prevent gaming of these caps. Treasury officials recognized that their proposal to require certain accruals following a plan amendment was a significant departure from existing law.

According to Treasury, “parallel” conversion requirements would apply to pension equity plans but these are not spelled out in the legislative proposal.

Age Discrimination

The proposal would clarify that cash balance plans would satisfy the age discrimination statutes as long as the pay credits provided to older workers were at least as generous as the pay credits provided to younger workers. Here as well, the proposal indicates that there will be parallel clarification under the age rules as to the validity of the pension equity design. The proposal would also make clear that transition strategies such as including the early retirement subsidy in the opening account balance would not violate the age rules. Treasury officials also recognize the potential non-discrimination and back-loading problems associated with certain conversion techniques and indicated that these problems will be addressed through future administrative guidance.

Whipsaw

Treasury officials began the whipsaw discussion by making clear they believed that the various courts of appeals that have ruled on whipsaw recently have reached the wrong outcome from a policy perspective and that plan participants are the losers under these cases. The Treasury proposal on whipsaw would not formally revoke Notice 96-8 but rather would institute an affirmative rule that the accrued benefit to be paid out in a cash balance plan would equal the account balance presuming the interest crediting rate was no greater than a “market” rate of interest. Market rates would be defined in subsequent Treasury guidance that would set out safe harbors for what constitutes a market rate of interest. The proposal does not speak to the issue of guaranteed minimum interest rates (so-called “floors”). In emphasizing the prospective nature of this whipsaw proposal, the Treasury made clear that the new rule on whipsaw would apply only to contributions after the date of enactment and that all prior contributions would be subject to current law on whipsaw (whatever that might be).

Brief Preliminary Analysis

The no inference as to the past on the basic age discrimination question (as well as the failure to protect in some way past conversions pursued and designed in good faith on then current legal authorities) is clearly problematic and employers will want to work with Congress to address these issues. Employers are also likely to be quite concerned about the precedent of requiring certain minimum benefits following a plan amendment. While the clarifications on the age and whipsaw questions are positive, the conversion requirements are fairly aggressive and could well be made more so through the legislative process.

James Delaplane, The Benefits Group of Davis & Harman LLP

