



AMERICAN BENEFITS COUNCIL

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BACKLOADING ISSUE: EFFECT ON BOTH HYBRID AND TRADITIONAL PLANS

As has been widely reported, companies that convert to cash balance plans have adopted a range of pro-participant transition benefits. The purpose of the transition benefits has been to eliminate or reduce any adverse effects of the conversion, while preserving the conversion's favorable aspects. A well-publicized example of such a transition benefit is allowing some or all participants to choose whether to be covered by the cash balance plan formula or to remain under the old formula. This allows participants to choose the formula that is best for them.

Although "choice" may be the most publicized transition approach, the generally most favorable transition approach is providing employees with the greater of the two formulas. In other words, instead of requiring employees to choose a formula, a "greater of" conversion calculates benefits under both formulas and provides the participant with the greater benefit automatically. That way, the employees do not have to guess, at the time of the conversion, how their careers will progress and which formula will end up as the more favorable for them.

The Pension Protection Act (the "PPA") did not require "choice" or "greater of," but certainly did not intend to prohibit such pro-participant transition approaches. Unfortunately, the IRS has decided that the generally most generous transition approach - - greater of - - violates the "backloading rules." The IRS' interpretation, which is based on a very old regulation, is inconsistent with the clear intent of the backloading rules. To explain the IRS' position, it is first necessary to discuss the backloading rules.

The backloading rules were enacted to prevent avoidance of the vesting rules. For example, under current law, all benefits under a defined benefit plan must be vested after an employee attains five years of service. Assume that an employer wants to avoid that rule and effectively require 30 years of service in order for a participant to be vested. The employer could theoretically provide that participants accrue \$1 per year for the first 29 years of service and accrue their full benefit in year 30; this would effectively result in 30-year vesting. To preclude such an end-run around the vesting rules, Congress enacted the backloading rules, which very generally require benefits to accrue ratably without any material increases in later years.

A plan that provides the greater of two formulas often frontloads benefits. A simple example illustrates this point. Assume that a plan's benefit formula provides 1% of career average pay multiplied by years of service. That formula is completely level, providing the same 1% every year. Assume, however, that the plan is modified to give employees a minimum benefit of 5% of career average pay. So the formula is the greater of (a) 1% of career average pay multiplied by years of service, or (b) 5% of career average pay. In that case, a participant would earn 5% in the first year (i.e., the minimum benefit). In the second through fifth year, there would be no net accrual because the ongoing formula benefit (1% per year) does not exceed the minimum benefit. Then in the sixth year, 1% per year accruals begin again. In short, the annual accrual pattern looks like this: 5%, 0%, 0%, 0%, 0%, 1%, 1%, etc.

Economically, the accrual pattern in this example is frontloaded, since the normal accruals for years one through five are all earned in year one. However, the IRS views this pattern as violating the backloading rules. The reason is that the formula jumps from 0% in year five to 1% in year six. The IRS interpretation does not recognize the true economic nature of the formula: over the first five years, the formula is frontloaded, and thereafter, the formula is neither frontloaded or backloaded. Certainly, there is no actual backloading nor any end-run around the vesting rules.

Please note that the above example includes a four-year period during which the participant does not earn any new accruals, which can be viewed as a type of wear-away period. There has been concern expressed regarding wear-away periods caused by the setting of a low opening account balance in a conversion to a cash balance plan. In those situations, eliminating wear-away helps participants. This situation is entirely different. The way to eliminate wear-away in this situation is to not have the 5% minimum benefit in the first place. That eliminates the wear-away but it is clear that such a change would hurt many participants and help none. So in these situations, the "cure" for wear-away is far worse for participants than the wear-away itself.

In the context of a conversion to a cash balance plan, the use of a greater of transition approach will, for many participants, result in the same type of accrual pattern as the above example: frontloading followed by ratable accruals. (This is true regardless of whether the greater of approach applies indefinitely or only for a temporary period of time, such as five or ten years.) A realistic illustration of this is attached, illustrating the accrual patterns in a plan that provides the greater of 1.5% of final average pay or a cash balance formula with a 5% pay credit and 4% interest credit, with no wear-away. Under the IRS' incorrect analysis, this pattern constitutes backloading, even though each formula separately satisfies the backloading rules and each participant will ultimately receive a benefit from only one of the two permissible formulas.

The result of the IRS' interpretation is the following. Prospectively, the most pro-participant transition approach - - indefinite greater of - - is prohibited. And temporary greater of formulas - - which are also very pro-participant - - are similarly prohibited. The companies that chose these pro-participant transition approaches in the past will be stunned

to learn that in order to avoid plan disqualification, they may have to pay potentially millions of dollars to cure this “problem.”

In addition, this backloading issue can apply to greater of formulas in other contexts. For example, traditional career average pay plans with a minimum benefit, including flat-dollar minimum benefits for hourly workers, are vulnerable under the IRS’ interpretation. This can arise in numerous contexts, including a corporate merger or acquisition where the seller’s employees may be provided the greater of the buyer’s formula or the seller’s formula, at least for a period of time. Also, plans can be required to provide the greater of the top-heavy minimum benefit or the plan’s regular formula, which may violate the backloading rules under the IRS’ interpretation (unless the IRS provides a special exemption with respect to the top-heavy minimum). To further illustrate the anomalous nature of the IRS’ position, greater of formulas used with final average pay plans or pension equity plans have the same accrual pattern but are not treated as violating the backloading rules. For technical reasons, career average pay plans and cash balance plans have this issue solely because they are based on pay during a participant’s full career.

The IRS’ interpretation needs to be reversed. If a plan provides the greater of two benefit formulas, each of which satisfies the backloading rules, the plan should be treated as satisfying the backloading rules.

Backloading Illustration¹

Year	Cash balance plan annual accrual	Traditional formula annual accrual	Cumulative cash balance accrual	Cumulative traditional accrual	Cumulative greater of accrual	Annual accrual
1	2.03%	1.50%	2.03%	1.50%	2.03%	2.03%
2	1.95%	1.50%	3.98%	3.00%	3.98%	1.95%
3	1.87%	1.50%	5.85%	4.50%	5.85%	1.87%
4	1.80%	1.50%	7.65%	6.00%	7.65%	1.80%
5	1.73%	1.50%	9.38%	7.50%	9.38%	1.73%
6	1.67%	1.50%	11.05%	9.00%	11.05%	1.67%
7	1.60%	1.50%	12.65%	10.50%	12.65%	1.60%
8	1.54%	1.50%	14.19%	12.00%	14.19%	1.54%
9	1.48%	1.50%	15.67%	13.50%	15.67%	1.48%
10	1.42%	1.50%	17.09%	15.00%	17.09%	1.42%
11	1.37%	1.50%	18.46%	16.50%	18.46%	1.37%
12	1.32%	1.50%	19.78%	18.00%	19.78%	1.32%
13	1.27%	1.50%	21.05%	19.50%	21.05%	1.27%
14	1.22%	1.50%	22.27%	21.00%	22.27%	1.22%
15	1.17%	1.50%	23.44%	22.50%	23.44%	1.17%
16	1.13%	1.50%	24.57%	24.00%	24.57%	1.13%
17	1.08%	1.50%	25.65%	25.50%	25.65%	1.08%
18	1.04%	1.50%	26.69%	27.00%	27.00%	1.35%
19	1.00%	1.50%	27.69%	28.50%	28.50%	1.50%
20	.96%	1.50%	28.65%	30.00%	30.00%	1.50%
21	.93%	1.50%	29.58%	31.50%	31.50%	1.50%
22	.89%	1.50%	30.47%	33.00%	33.00%	1.50%
23	.86%	1.50%	31.33%	34.50%	34.50%	1.50%
24	.82%	1.50%	32.15%	36.00%	36.00%	1.50%
25	.79%	1.50%	32.94%	37.50%	37.50%	1.50%

The first column shows the annual accruals under the cash balance formula, expressed on the basis of an age 65 annuity as required by the backloading rules. The second column shows the annual accruals under the traditional formula. The third and fourth columns show the cumulative accruals under the cash balance and traditional formulas, respectively. The fifth column shows the “greater of” the third and fourth columns, *i.e.*, the accruals to which the participant is entitled at any particular time. Finally, the last column shows the annual accruals under the “greater of” approach. The “backloading violation” occurs because the annual accruals increase from 1.08% in year 17 to 1.50% in year 19. This increase is entirely attributable to the fact that the cash balance formula frontloads accruals (on an age 65 annuity basis), but the IRS’ interpretation erroneously does not take that into account. The IRS’ interpretation thereby prohibits this pro-participant conversion approach while permitting less pro-participant conversion approaches.

¹ This illustration is based on a conversion from a 1.5% per year traditional defined benefit plan to a cash balance plan with 5% pay credits and 4% interest credits, with a transition rule that provides this participant with the greater of the two formulas indefinitely. The comparison is based on a 35-year old hired at the time of the conversion and, pursuant to the applicable regulations, compensation is assumed to remain constant.