Benefit Practice Portfolios, Regulations Provide Whipsaw Calculation Safe Harbor for Cash Balance Plans (November 2011)

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INTRODUCTION

The Pension Protection Act of 2006 (the "PPA") added Section 411(a)(13) to the Internal Revenue Code of 1986, as amended (the "Code").[1] Congress enacted Code Section 411(a)(13) to eliminate the "whipsaw calculation" for cash balance plans.[2] Prior to the PPA, cash balance plans used the whipsaw calculation to convert a hypothetical account balance to an annuity payable at normal retirement age, and, then, discount the annuity to a lump sum. Code Section 411(a)(13) provides a safe harbor allowing a cash balance plan to distribute the current hypothetical account balance in the form of a lump sum distribution.

Since Congress enacted the PPA in 2006, practitioners have struggled to apply the rules to cash balance plans—as the Treasury Department and the Internal Revenue Service (the "IRS") drafted regulations. In 2007, a set of proposed regulations interpreted the requirements for taking advantage of the whipsaw calculation safe harbor under Code Section 411(a)(13).[3] On October 19, 2010, the Treasury Department and the IRS issued final regulations, which generally adopted the 2007 proposed regulations, and new proposed regulations.[4] The new 2010 proposed regulations proffered new conditions and requirements for applying the whipsaw safe harbor.

This Article explains the impact of the 2010 final and proposed regulations under Code Section 411(a)(13) on cash balance plans. The first part provides background on the fundamental features of cash balance plans, and reviews the scope of the 2010 final and proposed regulations. The second part analyzes the new 3-year cliff minimum vesting schedule for cash balance plans. The third part explains the whipsaw calculation-related rules and conditions included in the 2010 final and proposed regulations. The fourth part discusses the statutory effective dates and regulatory applicability dates for Code Section 411(a)(13).

CASH BALANCE PLANS UNDER THE FINAL AND PROPOSED REGULATIONS

The final regulations contain rules establishing the scope of the plans affected by the vesting and whipsaw calculation requirements under Code Section 411(a)(13). Statutory hybrid plans must comply with the requirements under Code Section 411(a)(13).[5] A statutory hybrid plan is a type of defined benefit plan. The defining characteristic of a statutory hybrid plan is the type of formula used to determine a participant's benefit. For purposes of this Article, the benefit formula is called a statutory hybrid benefit formula that is a lump sum based-benefit formula. A plan need not include a lump-sum payment option to be a statutory hybrid plan.[6]

In general, cash balance plans use a lump sum based-benefit formula to determine a participant's benefit accrued to date. A cash balance benefit formula expresses the participant's benefit as the current value of a participant's hypothetical account, i.e., as a lump sum.

Nonetheless, it is not adequate to broadly classify certain types of plans as a statutory hybrid plans. Many different facts weigh in on such an analysis. Before analyzing the factors, this Part reviews how cash balance plans function and why they act like defined contribution plans. Thereafter, this Part analyzes the features that render a cash balance plan a statutory hybrid plan within the scope of Code Section 411(a)(13). This Part is integral to subsequent Parts that analyze how to apply the 3-year vesting schedule and the whipsaw safe harbor.

Cash Balance Plans: A Type of Defined Benefit Plan that Acts Like a Defined Contribution Plan

Cash balance plans are a type of defined benefit plan that functions like a defined contribution plan. The benefit formula stated in a cash balance plan gives rise to the concept. A cash balance benefit formula grants a participant a principal credit for each year of service. The participant then earns an interest credit on each principal credit until retirement.[7] The value of a participant's benefit as of any point in time equals the value of a participant's principal credits, plus interest credits earned thereon, stated as a hypothetical account balance.[8]

> For example, Plan A is a cash balance plan that grants an annual principal credit to a participant equal to 7% of his compensation for the year, with an interest credit of 5%. Participant Z earns $100,000 in 2010, and a principal credit equal to $7,000 is added to his hypothetical account. In each subsequent year, a 5% interest credit is earned on the principal credits in Participant Z's hypothetical account. After 4 years of service, Participant Z has 4 principal credits, with interest credits, in his hypothetical account. Thus, the current value of his 4 principal credits and the interest credits is the current value of Participant Z's hypothetical account balance.

Although a cash balance plan is a type of defined benefit, a cash balance plan possesses qualities of a defined contribution plan. Cash balance plans and defined contribution plans both express the current value of a participant's benefit as the balance of an account. A participant's benefit under a cash balance plan as of a point in time is the value of his hypothetical account balance, e.g., the total value of principal credits and the interest credits earned thereto. Similarly, a defined contribution plan participant has a benefit equal to his account balance, e.g., the balance of elective deferral contributions, matching contributions, and earnings thereon.

Unlike account balance features of cash balance and defined contribution plans, a benefit under a traditional defined benefit plan is an annuity payable at normal retirement age. The type of formula used to determine a participant's benefit accrued to date drives the distinction. Cash balance plan benefit formulas produce the lump sum value of a participant's benefit accrued to date. At any time, a participant may look at his hypothetical account balance and determine the lump sum value of the benefit determined under the cash balance benefit formula. In contrast, under a traditional defined benefit plan formula, a participant's benefit is expressed as an annuity payable at normal retirement age.

> For example, Company B sponsors Plan Y, a cash balance plan. Under Plan Y's benefit formula, a participant earns a 6% annual principal credit, up to 30 years of service, with 5% interest credits. Participant J has 20 years of service at age 55 and, thus, earned 20 principal credits with interest credits thereon. The current value of Participant J's hypothetical account balance is equal to the value of his 20 principal credits, and the interest credits, awarded to date. Based on this formula, assume that Participant J's current hypothetical account balance equals $200,000.

> For example, Company A sponsors Plan X, a traditional defined benefit plan. Under Plan X's benefit formula, a participant's benefit formula is equal to: (i) 50% of a participant's highest average annual earnings over a full year period if he has 30 or more years of service, or (ii) 50% of his highest average annual earnings multiplied by a fraction, the numerator of which is his years of service and the denominator of which is 30, if he has less than 30 years of service. Participant K, who is not married, earned 30 years of service and retires at Plan X's normal retirement age of 65. Participant K's highest average annual earnings over a full year period equaled $80,000. Thus, Participant K earned a benefit equal to $40,000 payable annually as an annuity for life.

Cash Balance Plans and the Scope of the Regulations

The whipsaw calculation and 3-year vesting schedule requirements apply to statutory hybrid benefit plans that contain a lump sum based-benefit formula. Determining whether a cash balance plan has a lump sum based-benefit formula is the first step to analyzing the applicability of the rules under Code Section 411(a)(13).

The touchstone of a lump sum based-benefit formula is that it expresses a participant's accumulated benefit, as opposed to the participant's accrued benefit.[9] A participant's accrued benefit is expressed as an annual annuity commencing at normal retirement age.[10] A traditional defined benefit plan benefit formula

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produces a benefit payable as a life annuity commencing at normal retirement age. As accumulated benefit is expressed as the benefit accrued to date.[11] A benefit under a cash balance plan formula provides the accumulated benefit. It is the accumulated benefit because a participant's benefit accrued as of any point in time is communicated as the balance of a hypothetical account.

The accrued benefit and accumulated benefit concepts are separate and distinct. The accrued benefit definition under a plan has no impact on the accumulated benefit. This is true even if a plan defines the accrued benefit as the actuarial equivalent of the accumulated benefit, payable as an annuity beginning at normal retirement age.[12]

For example, the accumulated benefit under a cash balance plan is expressed as a participant's hypothetical account balance, determined by the principal credits and interest credits to date. Put another way, a participant's hypothetical account balance is his benefit accrued to date. The cash balance plan also provides that the participant's accrued benefit is the actuarial equivalent of his then-current hypothetical account balance payable as a life annuity at normal retirement age. To determine the participant's accrued benefit, the participant's account balance is converted, using actuarial assumptions stated in the plan, to an annuity payable at normal retirement date. The cash balance plan separately calculates and communicates the participant's accumulated benefit and accrued benefit.

A cash balance plan contains a lump sum based-benefit formula even if it contains several benefit formulas and only of them is a cash balance benefit formula.[13] Cash balance plans commonly have several benefit formulas if there was conversion from a traditional defined benefit plan to a cash balance plan or if a traditional defined benefit plan merged into a cash balance plan. For a plan merger, different benefit formulas might apply to different segments of the participant population. Some participants who transferred to the plan pursuant to the merger may have their benefit determined by reference to both the predecessor plan's traditional defined benefit formula and the cash balance benefit formula. The cash balance plan would still contain a lump sum based-benefit formula and, thus, fall within the scope of the requirements under Code Section 411(a)(13).

For example, Company E acquired Company F. Company E sponsors Plan R, a cash balance plan. Company F sponsored Plan S, a traditional defined benefit plan that merged into Plan R. The participants in Plan S who transferred into Plan R after the acquisition received a benefit equal to the greater of: (1) the benefit under Plan S's traditional defined benefit formula; or (2) the benefit under the cash balance benefit formula, including an opening account balance equal to the benefit under Plan S as converted. All other participant's in Plan R earned a benefit accrued to date under the cash balance benefit formula, without reference to a traditional defined benefit formula. After the acquisition of Company F and the merger of Plan S into Plan R, Plan R still has a lump sum based-benefit formula, meaning Plan R is a statutory hybrid plan. This is true even though some participants who transferred to Plan R may receive a benefit that is determined under the traditional defined benefit plan formula under Plan S.

Features Not Affecting Whether a Plan is a Statutory Hybrid Plan

Two special rules apply when determining whether a plan has a lump sum based-benefit formula. First, whether a cash balance plan includes a lump sum distribution option is irrelevant.[14] A plan may contain a lump sum based-benefit formula even if the plan does not offer a lump sum distribution option. The fact that a participant's accrued benefit is the actuarial equivalent of his accumulated benefit has no bearing on whether a benefit formula is a lump sum-based benefit formula.[15]

For example, Plan W is a cash balance plan that expresses a participant's accumulated benefit as his hypothetical account balance. Plan W defines a participant's accrued benefit as the actuarial equivalent of a participant's hypothetical account balance payable as an annuity at normal retirement age. Several different distribution forms are offered under Plan W, including a 50% qualified joint and survivor annuity. But a lump sum distribution option is not among the available distribution forms. Despite the absence of a lump sum distribution option, Plan W still contains a lump sum based-benefit formula. Therefore, Plan W is a statutory hybrid plan.

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Second, the fact that a defined benefit plan, whether or not it is a cash balance plan, includes employee contributions does not impact whether or not it is a statutory hybrid plan.[16] The general rule applies to after-tax employee contributions, rollover contributions and other types of employee contributions. Employee contributions expressed as an account balance do not cause a defined benefit plan to contain a lump sum based-benefit formula.

> For example, Company C sponsors Plan T, a contributory defined benefit plan under which participant contributions are required for benefit accruals. Participant O began participating in Plan T. The contributions made by Participant O do not cause Plan T to be a lump sum based-benefit formula. Consequently, Plan T is not a statutory hybrid plan, and, thus, need not worry about Code Section 411(a)(13).

For the applicable effective dates for Code Section 411(a)(13)(A) and the final regulations thereunder, please refer to the Part entitled "Statutory and Regulatory Applicability and Effective Dates."

VESTING REQUIREMENTS APPLICABLE TO CASH BALANCE PLANS

After the PPA, a statutory hybrid plan can no longer satisfy the minimum vesting requirements by complying with the standard statutorily prescribed minimum vesting requirements applicable to defined benefit plans, i.e., a 5-year cliff or 3 to 7 year graded vesting schedule.[17] Code Section 411(a)(13)(B) provides new minimum vesting standards for statutory hybrid plans. A statutory hybrid plan must vest accrued benefits using a 3-year vesting schedule.[18] The final regulations provide rules for applying the new minimum vesting requirements.

Applying the Minimum Vesting Requirements

In general, any defined benefit plan that is a statutory hbrid plan must comply with the new minimum vesting requirements. Accordingly, a cash balance plan must vest benefits using a 3-year cliff vesting schedule.

The 3-year vesting schedule applies on a participant-by-participant basis.[19] The regulations do not broadly assign the 3-year vesting schedule to all participants under a plan merely based on its status as a statutory hybrid plan. Determining whether the 3-year vesting schedule applies to certain participants requires an analysis of how different segments of the participant population have their benefits determined. Different segments of the participant population may be covered under more than one formula due to, for example, a plan merger or a cash balance plan conversion.

The type of formula used to determine a participant's benefit drives whether the 3-year vesting schedule applies to a participant. If any portion of a participant's benefit is determined under a cash balance plan formula, the 3-year vesting schedule applies to a participant's entire benefit. It does not apply only to the portion of a participant's benefit determined using the cash balance plan formula.[20]

In applying these principles, practitioners should consider how the minimum vesting standards apply to different types of benefit formulas. The first type is a sum-of benefit formula. A plan under which a participant's benefit is determined using a sum-of benefit formula must apply the 3-year vesting schedule to the participant's entire benefit.[21]

> For example, Participant A participated in Plan M, a traditional defined benefit plan, before it was converted to a cash balance plan on July 1, 2007. Participant A continues to participate in Plan M after the cash balance plan conversion. Participant A's benefit is equal to the sum-of: (1) the benefit under Plan M's traditional defined benefit formula, as of June 30, 2007; and (2) the benefit determined under the cash balance benefit formula, since July 1, 2007. The 3-year vesting schedule applies to Participant A because a portion of his benefit is determined under a cash balance plan formula.

A plan with multiple benefit formulas is another type of plan that creates issues when applying the 3-year vesting schedule. A plan that uses multiple benefit formulas may or may not need to vest each participant's benefit according to a 3-year vesting schedule.[22] The issue arises when different benefit formulas apply to different portions of the participant population.

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For example, Plan A is sponsored by Company W, and Plan B is sponsored by Company X. Plan A is a cash balance plan that uses a cash balance benefit formula. Plan B is a traditional defined benefit plan with a final average pay formula. Company W acquires Company X, merging Plan B into Plan A. As part of the merger, Plan B participants are permitted to continue accruing benefits under the traditional defined benefit formula under Plan B.

Participants with a benefit determined under the cash balance portion of Plan A must vest according to the 3-year vesting schedule. Participants who transferred into Plan A from Plan B, whose benefit continues to be calculated under the traditional defined benefit formula may apply either a 5-year cliff or 3 to 7 year graded vesting schedule, which are the standard schedules for traditional defined benefit plan benefits.

A plan with a greater-of benefit formula requires a different analysis for applying the 3-year vesting schedule. A greater-of benefit formula commonly arises where a plan is converted from a traditional defined benefit formula to a cash balance plan. Participant benefits calculated under a greater-of formula must apply the 3-year vesting schedule.[23] This is the rule even when the greater-of benefit formula causes a participant's benefit to be determined under a formula that is not a lump sum based-benefit formula, e.g., a traditional defined benefit formula.

For example, Participant A participated in Plan M, a traditional defined benefit plan, before it was converted to a cash balance plan on July 1, 2007. Participant A continues to participate in Plan M after the conversion. Participant A's benefit is equal to the greater of: (1) the benefit determined under the traditional defined benefit formula; and (2) the benefit under the traditional defined benefit formula as it was converted to the opening balance of a participant's hypothetical account, as of July 1, 2007, plus the benefit determined under the cash balance formula since July 1, 2007. Participant A's benefit must vest according to a three-year vesting schedule, regardless of whether (1) or (2) above is greater.

Finally, a plan with an offset benefit formula may or may not need to use the 3-year vesting schedule.[24] Under a plan with an offset benefit formula, a participant's benefit is calculated with reference to the benefit determined under a formula that is stated under a separate and distinct plan. Examples provide the best method for explaining the general rule.

For example, Plan F determines a participant's benefit using a cash balance formula. Plan G calculates a participant's benefit as the difference between the benefit determined under a traditional defined benefit formula stated under the terms of Plan G and the benefit determined under the cash balance benefit formula in Plan F. In this example, Plan G is not required to determine a participant's nonforfeitable benefit using the 3-year vesting schedule even though a participant's benefit under Plan G is determined with reference to the cash balance benefit formula under Plan F. The 3-year vesting schedule does not apply to Plan G because it does not contain a lump sum based-benefit formula, i.e., it is not a statutory hybrid plan. A participant's nonforfeitable benefit under Plan F must, of course, use the 3-year vesting schedule.

For the applicable effective dates for Code Section 411(a)(13)(B) and the final regulations thereunder, please refer to the Part entitled "Statutory and Regulatory Applicability and Effective Dates."

WHIPSAW CALCULATION SAFE HARBOR

Code Section 411(a)(13)(A) provides a safe harbor for the whipsaw calculation to statutory hybrid plans that contain a lump sum based-benefit formula. A plan that complies with whipsaw calculation safe harbor requirements is not treated as failing to meet certain qualification requirements merely because the lump sum value of a participant's accrued benefit, under a cash balance benefit formula, is equal to the then-current balance of the hypothetical account. In other words, Code Section 411(a)(13)(A) allows plans to refrain from converting the current balance of a hypothetical account balance to an annuity payable at normal retirement age, and then back to a lump sum, when a participant elects a lump sum distribution option. Without the need to perform the "whipsaw" calculation, the amount of a participant's lump sum benefit is simply his current hypothetical account balance.

The final and proposed regulations provide guidance for applying the whipsaw safe harbor. The final regulations define what types of statutory hybrid plans may take advantage of the 411(a)(13)(A) safe harbor.

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The proposed regulations provide guidance for applying the safe harbor to sum-of and greater-of benefit formulas. In addition, the proposed regulations impose certain conditions on the Code Section 411(a)(13)(A) safe harbor, and extend the safe harbor to optional benefit forms other than a lump sum distribution.

Whipsaw Calculation and Safe Harbor Explanation

A plan to which Code Section 411(a)(13)(A) applies is not required to convert the current value of a participant's hypothetical account to the accrued benefit when calculating certain option forms of payment. By not performing this conversion, a participant who, for example, elects to receive a lump sum distribution will receive the accumulated benefit provided under a formula that is expressed as the balance of a hypothetical account. A plan not covered by Code Section 411(a)(13)(A) could only pay a lump sum in this amount if it was at least as large as the present value[25] of the participants accrued benefit.

Under the whipsaw calculation safe harbor, a participant receives the balance of his hypothetical account as the lump sum payment. A plan that takes advantage of the whipsaw safe harbor may use the simplified lump sum method. In other words, if a statutory hybrid plan complies with the 3-year vesting requirement that was explained earlier in this Article, complies with other applicable requirements, and pays a lump sum equal to the accumulated benefit, the plan is also treated as satisfying the requirements under Code Sections 411(a)(11), 411(c), and 417(e), which concerns the present value benefit calculation.

Rules for Applying the Whipsaw Safe Harbor

The regulations provide rules for applying the whipsaw safe harbor to statutory hybrid plans that contain a lump sum-based benefit formula.[26]

Applicable Plans

The whipsaw safe harbor only applies to part of a greater-of benefit formula under a statutory hybrid plan with a lump sum based-benefit formula, e.g., a cash balance plan.[27] In such a plan, the benefit is equal to the greater of: (1) the benefit determined under a lump sum-based benefit formula, and (2) the benefit determined under a benefit formula that is not a lump sum-based benefit formula. The issue with applying the safe harbor to a greater-of benefit formula is the fact that more than one benefit formula is involved. The key issue becomes whether to apply the safe harbor relief to one or all components of the greater-of benefit formula, i.e., whether the portion of a greater-of benefit formula that is not a lump sum-based benefit formula needs to comply with the present value requirements under Code Section 417(e). The proposed regulations state that the portion of a greater-of benefit formula that is not a lump sum-based benefit formula gets no relief from Code Section 411(a)(13)(A). As a result, for example, a participant who elects to receive a lump sum distribution will receive the greater of: (1) the present value of the current balance of his hypothetical account, and (2) the present value of the benefit determined under a formula that is not a lump sum-based benefit formula after applying the present value requirements under Code Section 417(e).

> For example, a traditional defined benefit plan was converted to a cash balance plan. The cash balance plan satisfies the requirements for the whipsaw calculation safe harbor. Under the cash balance plan, a participant's benefit is the greater of: (1) the benefit he would have received under the traditional defined benefit formula if the formula had continued without change; or (2) the benefit determined under the cash balance benefit formula. Participant A, who terminates employment at age 40, elects to receive a lump sum payment. To determine the amount of the participant's benefit, the plan must determine which is greater, (1) or (2) above. The benefit under (1) is expressed as annuity payable at normal retirement age, so the plan is required to apply the present value requirements under Code Section 417(e) to convert the annuity to a lump sum. The benefit under (2) is the current balance of the participant's hypothetical account because the plan satisfies the whipsaw safe harbor. Thus, the participant will receive a lump sum distribution equal to the greater of (1) and (2).

The proposed regulations also provide guidance for applying the safe harbor to a statutory hybrid plan that uses a sum-of benefit formula.[28] Under such a plan, the benefit is equal to the sum of: (1) the benefit determined under a lump sum-based benefit formula, and (2) the benefit determined under a formula that is not a lump sum-based benefit formula that is in excess of the benefit determined under the lump sum-based benefit formula. Similar to the greater-of benefit rule discussed in the previous paragraph, the relief under Code Section 411(a)(13)(A) only applies to the portion of the benefit formula that is a lump sum-based

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benefit formula. If a participant requests a lump sum distribution from a plan with the sum-of benefit formula discussed above, the current value of the balance of the participant's hypothetical account is one portion of the benefit. In addition, the other benefit will yield an amount after performing the present value calculation, as required by Code Section 417(e). The amount determined under the benefit formula that is not a lump sum based-benefit formula, that is in excess of the benefit determined under the lump sum based-benefit formula, is added to the balance of the hypothetical account under the lump sum-based benefit formula, thus producing the amount of the participant's lump sum payment. Many plans with this structure only offer a lump sum payment option on the account balance portion of the benefit. In that case a participant electing a lump sum, would make a separate residual annuity election on the remaining benefit.

Conditions for Safe Harbor Relief

The proposed regulations contain a list of three conditions that a plan must satisfy to receive relief under Code Section 411(a)(13)(A).[29] Each of the three conditions is discussed below.

First, the present value of the portion of a participant's benefit determined under a cash balance benefit formula on or before the participant's normal retirement age cannot be less than the benefit payable in the form of an annuity at normal retirement age.[30] To evaluate the account balance on or before normal retirement age, the plan is directed to use reasonable actuarial assumptions. In general, this condition is cumbersome. A plan would need to apply reasonable actuarial assumptions to verify that a participant's account balance, as of each point in time prior to and on a participant's normal retirement age, is not less than the present value of the annuity payable at normal retirement age.

> For example, Plan D is a cash balance plan, with an age 65 normal retirement age, that wants to take advantage of the whipsaw safe harbor. Participant T, who is 35 years old, has 7 years of principal credits worth 7% of annual compensation, with interest credits thereon, and the balance of his hypothetical account is currently $65,000. To qualify for the whipsaw safe harbor, Plan D must demonstrate that the $65,000 account balance is not be less than the present value of the annuity payable at normal retirement age, determined using reasonable actuarial assumptions. This must be true from the time Participant T is age 35 up through and including the time he reaches age 65.

To avoid performing the whipsaw calculations before a participant reaches normal retirement age, the plan may satisfy a special safe harbor exception.[31] The special safe harbor exception is satisfied if a participant's hypothetical account balance is equal to the actuarial equivalent of a participant's benefit payable as an annuity upon attainment of normal retirement age using reasonable assumptions. In other words, a plan would not need to determine whether a participant's hypothetical account balance is actuarially equivalent to an annuity payable at normal retirement age until a participant actually reaches normal retirement age. Thus, the first condition presents a less onerous burden for plans using the special safe harbor.

The proposed regulations do not provide guidance on what actuarial assumptions constitute reasonable actuarially assumptions for purposes of satisfying the first condition. The final regulations hopefully will include guidance.

Second, the whipsaw safe harbor is not permitted unless, as of each annuity starting date after a participant attains normal retirement age, the then-current value of a participant's hypothetical account satisfies certain conditions.[32] After a participant passes the plan's normal retirement age, the participant's hypothetical account must provide for an increase to make up for any benefits lost due to not receiving benefits at normal retirement age. Similarly, a participant's hypothetical account must receive accrual increases sufficient to make up for any benefits lost as a result of a suspension of benefits.

Third, a participant's accumulated benefit cannot be reduced.[33] The proposed regulations, however, include a few exceptions under which the participant's hypothetical account balance may be reduced. Below is a list of the exceptions:

- Benefit paid under an optional form of benefit other than a lump sum distribution (as discussed below in the "Other Optional Distributions Forms" Section);
- Qualified domestic relations orders under Code Section 414(p);

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- Forfeitures permitted under Code Section 411(a) (such as charges for providing a qualified pre-retirement survivor annuity);
- Amendments permitted under Code Section 411(d)(6); or
- Adjustments resulting from applying interest credits[34] that are negative for a period, for plans that express the accumulated benefit as the balance of a hypothetical account.

Relief for Other Optional Distribution Forms

Although Code Section 411(a)(13) only extends the whipsaw calculation safe harbor to lump sum distributions, the proposed regulations grant safe harbor relief for certain other optional distribution forms.

The proposed regulations provide rules for applying the relief under Code Section 411(a)(13)(A) to an optional distribution form other than a lump sum payment. The safe harbor applies to an optional form of benefit, provided certain requirements are met.[35] The benefit payable in an optional form is determined as of the annuity starting date and is the actuarial equivalent of the account balance determined using reasonable assumptions. Without the safe harbor, a plan would need to convert the hypothetical account balance to the accrued benefit as stated in the plan terms, and, then, convert this annuity to an optional distribution form. With the safe harbor, however, the plan may simply convert the hypothetical account balance to the actuarial equivalent of an optional form of benefit payable as of the annuity starting date. The plan must use reasonable actuarial assumptions. The final regulations hopefully will include guidance.

Relief is also provided under the proposed regulations for the conversion of a benefit determined under a lump sum based-benefit formula to an optional form not subject to the minimum present value requirement under Code Section 417(e), e.g., joint and survivor annuity or life annuity, and is determined under the plan as the actuarial equivalent of an optional form of benefit that: (1) commences as of the same annuity starting date; (2) is payable in the same generalized optional form[36] as the accrued benefit; and (3) is the actuarial equivalent (using reasonable actuarial assumptions) of the then-current balance of a hypothetical account maintained for the participant.[37]

Third, the proposed regulations provide guidance for applying relief to a distribution option where part of the distribution option is payable in a form to which the safe harbor relief applies and the remainder is not.[38] The relief applies proportionately to the portion that is paid in a form to which the safe harbor applies and to another form to which it does not apply.

> For example, a plan defines the participant's accumulated benefit as the value of his hypothetical account balance and the participant elects to receive 40% of his account balance as a lump sum payment and the other 60% as a joint and survivor annuity commencing prior to normal retirement age that does not qualify for safe harbor relief. The relief would only apply to the 40% that is taken as a lump sum. The 60% portion would need to comply with the qualification requirements for which relief is provided to the 40% of the account balance that is distributed. The same logic would apply if the 60% of the account balance was distributed in a form for which relief is provided under the proposed regulations, such as a life annuity commencing prior to normal retirement age. The 40% would satisfy the relief, and the 60% would qualify for relief so long as the additional conditions, as applicable, are satisfied.

Commentators have recognized that the safe harbor relief for optional benefit forms is capable of two different interpretations. Under the first interpretation, optional benefit forms, other than a lump sum option, commencing prior to normal retirement age may be determined by converting the account balance to the optional benefit form.[39] The conversion from the account balance to an optional benefit form would not be required to convert the account balance to an accrued benefit and, then, convert the accrued benefit to the optional annuity form. In other words, the safe harbor simplifies the method for converting the account balance to an optional form commencing prior to normal retirement age. Under the second interpretation, the rules eliminate the ability to provide a retirement subsidy to participants.[40] Employers commonly subsidize benefits by providing a more favorable formula than a participant would otherwise receive, e.g., allowing an early retirement benefit without a reduction for early commencement. The argument claims that the proposed regulations would prohibit employers from providing subsidized benefits because optional benefit forms

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would be required to equal a participant's account balance. Treasury Department and IRS officials have stated that they will resolve the issue in the final regulations.

For the effective dates for Code Section 411(a)(13)(A) and the final regulations thereunder, please refer to the Part entitled "Statutory and Regulatory Applicability and Effective Dates."

STATUTORY AND REGULATORY APPLICABILITY AND EFFECTIVE DATES

The final and proposed regulations distinguish between the effective date of Code Section 411(a)(13), pursuant to the PPA, and applicability date of the regulations. The time between these two periods is referred to herein as the interim period. During the interim period, plans may rely on guidance issues prior to the regulations.

Whipsaw Safe Harbor

The whipsaw safe harbor only applies to distributions made after August 17, 2006.[41] Congress considered applying the safe harbor retroactively to bar claims, but did not do so.[42] Thus, claims arising from distributions made on or before August 17, 2006 receive no relief from Code Section 411(a)(13).

The chart below provides effective date information for the whipsaw safe harbor. The first column is the statutory effective date for the PPA. The second column references the final and proposed regulations under Code Section 411(a)(13)(A). The final and proposed regulations are separated into two rows for ease of reference. The third column lists the regulatory applicability date for the final and proposed regulations. As with the second column, the regulatory applicability dates are divided into two rows based on the applicable regulatory section. The date listed is the "effective date" of the regulations. The fourth column states the requirements for the interim period, i.e., the period between the statutory effective date and regulatory applicability dates.

Statutory Effective Date	Final & Proposed Regulations	Regulatory Applicability Date	Interim Period
Distributions made after August 17, 2006	Final Treas. Reg. §1.411(a)(13)-1(b)(2)	Plan years that begin on or after January 1, 2011	Plan must satisfy requirements of Code Section 411(a)(13)(A)
	Prop. Treas. Reg. §1.411(a)(13)-1(b)(2), (b)(3), (b)(4)	Plan years that begin on or after January 1, 2012	Plan may rely on the final regulations. Plan may also rely on the 2010 proposed regulations, the 2007 proposed regulations, and Notice 2007-6 for applying the relief and satisfying the requirements of Code Section 411(a)(13)(A)

3-Year Vesting Schedule

The charts below provides effective date information for Code Section 411(a)(13)(B). The first column differentiates between the types of statutory hybrid plan that have unique effective dates. The second column is the statutory effective date. The statutory effective dates are divided into several rows so as to align with the statutory hybrid plan types listed in the first column. The third column lists the regulatory applicability date for the regulations. The fourth column states the requirements for the interim period, i.e., the period between the statutory effective date and regulatory applicability dates.

Type of Plan	Statutory Effective	Regulatory	Interim Period

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	Date	Applicability Date	
Plan in existence on June 29, 2005 (regardless of whether the plan is a statutory hybrid plan on that date)	Plan years that begin on or after January 1, 2008		Plan must satisfy requirements of Code Section 411(a)(13)(B)
Plan that was in existence on June 29, 2005 (regardless of whether the plan was a statutory hybrid plan on that date) with a plan sponsor who elected to have Code Section 411(a)(13)(B) apply for any period on or after June 29, 2005, and before the first plan year beginning after December 31, 2007[43]	Date of plan sponsor election	Plan years that begin on or after January 1, 2011	Plan may rely on the final regulations. Plan may also rely on the 2010 proposed regulations, the 2007 proposed regulations, and Notice 2007-6 for applying the relief and satisfying the requirements of Code Section 411(a)(13)(B)
Plan not in existence on June 29, 2005 Collectively bargained plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified on or before August 17, 2006 A plan with respect to which a collective bargaining agreement applies to some, but not all, of the plan participants, the plan is considered a collectively bargained plan for purposes of paragraph (e)(1)(iii)(C) of this section if it is considered a collectively bargained plan under the rules of §1.436-1(a)(5)(ii)(B).	Plan years that end on or after June 29, 2005 Do not apply to plan years that begin before the earlier of— (1) The later of— (i) The date on which the last of those collective bargaining agreements terminates (determined without regard to any extension thereof on or after August 17, 2006); or (ii) January 1, 2008; or (2) January 1, 2010.		

43 In accordance with section 1107 of the PPA '06, an employer is permitted to adopt an amendment to make this election as late as the last day of the first plan year that begins on or after January 1, 2009 (January 1, 2011, in the case of a governmental plan as defined in section 414(d)) if the plan operates in accordance with the election.

Footnotes

1 P.L. 109-280, §701(b)(2). The PPA added an identical provision to Section 203(f) to the Employee Retirement Income Security Act of 1974 ("ERISA"). Id. §701(a)(2). The Worker, Retiree, and Employer

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Recovery Act of 2008 ("WRERA"), P.L. 110-458, §107(a)(1), (b)(2)(A)-(C), amended Code Section 411(a)(13) and ERISA Section 203(f).

2 The rules under Code Section 411(a)(13) apply to both cash balance plans and pension equity plans. Treas. Reg. §1.411(a)(13)-1(d)(5). This article, however, focuses on the application of Code Section 411(a)(13) to cash balance plans.

3 72 Fed. Reg. 73680 (Dec. 28, 2007).

4 Treas. Reg. §1.411(a)(13)-1; Prop. Treas. Reg. §1.411(a)(13)-1. The Treasury Department and the IRS also issued final and proposed regulations under Code Section 411(b)(5). Although the requirements under Code Sections 411(a)(13) and 411(b)(5) both affect cash balance, this Article only addresses the requirements under Code Section 411(a)(13). Code Sections 411(a)(13) and 411(b)(5) provide technical rules that intersect. A general broad-based analysis of cash balance plan PPA compliance should consider both sets of rules.

5 Treas. Reg. §1.411(a)(13)-1(d)(5).

6 Treas. Reg. §1.411(a)(13)-1(d)(3)(i).

7 Code Section 411(b)(5)(h)(i) and the regulations thereunder limit interest credits to an amount not greater than the market rate of return. These rules are beyond the scope of this Article.

8 The proposed regulations requested comments on whether a plan that expresses a participant's accumulated benefit as a single sum dollar amount and does not provide interest credits should be excluded from the definition of statutory hybrid plans. Prop. Treas. Reg. §§1.411(a)(13)-1 and 1.411(b)(5)-1.

9 Treas. Reg. §1.411(a)(13)-1(d)(2).

10 IRC §411(a)(7)(A).

11 Treas. Reg. §1.411(a)(13)-1(d)(2).

12 Treas. Reg. §1.411(a)(13)-1(d)(2).

13 Treas. Reg. §1.411(a)(13)-1(d)(3).

14 Treas. Reg. §1.411(a)(13)-1(d)(3)(i).

15 Treas. Reg. §1.411(a)(13)-1(d)(3)(i).

16 Treas. Reg. §1.411(a)(13)-1(d)(3)(ii).

17 IRC §411(a)(2).

18 IRC §411(a)(13)(B).

19 Treas. Reg. §1.411(a)(13)-1(c)(1).

20 Treas. Reg. §1.411(a)(13)-1(c)(1).

21 Treas. Reg. §1.411(a)(13)-1(c)(1), (c)(2) Ex/1.

22 Treas. Reg. § 1.411(a)(13)-1(c)(2) Ex/2.

23 Treas. Reg. §1.411(a)(13)-1(c)(1).

24 Treas. Reg. §1.411(a)(13)-1(c)(1), (c)(2) Ex/3.

25 Present value determined using actuarial assumptions under Code section 417(e)(3).

26 Treas. Reg. §1.411(a)(13)-1(b)(1).

27 Prop. Treas. Reg. §1.411(a)(13)-1(b)(4)(i).

28 Prop. Treas. Reg. §1.411(a)(13)-1(b)(4)(ii).

29 Prop. Treas. Reg. §1.411(a)(13)-1(b)(2)(i).

30 Prop. Treas. Reg. §1.411(a)(13)-1(b)(2)(ii).

31 Prop. Treas. Reg. §1.411(a)(13)-1(b)(2)(ii).

32 Prop. Treas. Reg. §1.411(a)(13)-1(b)(2)(iii).

33 Prop. Treas. Reg. §1.411(a)(13)-1(b)(2)(iv).

34 Under the rules of Treas. Reg. §1.411(b)(5)-1.

35 Prop. Treas. Reg. §1.411(a)(13)-1(b)(3)(ii).

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36 Within the meaning of Treas. Reg. §1.411(d)-3(g)(8).

37 Prop. Treas. Reg. §1.411(a)(13)-1(b)(3)(iii).

38 Prop. Treas. Reg. §1.411(a)(13)-1(b)(3)(iv).

39 Comment Letter on Additional Rules Regarding Hybrid Retirement Plans, from Russell Hall, Michael Pollack, and Maria Sarli of Towers Watson to the Internal Revenue Service (dated January 11, 2011).

40 Comment Letter on Regulating Subsidies in Hybrid Pension Plan, from Julie Edmond, Covington & Burling LLP to the Internal Revenue Service (dated January 12, 2011).

41 West v. AK Steel Corp., 484 F.3d 395, 412 (6th Cir.2007); Traylor v. Avnet, Inc., 2009 WL 383594 (D.C. Ariz. 2009).

42 West v. AK Steel Corp., 2009 WL 2884150 (S.D. Ohio 2009).

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