



For your information

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PBGC Issues Proposed Regulations on Benefit Determinations for Terminating Statutory Hybrid Plans

The PBGC recently issued proposed regulations that would amend its rules to make them consistent with PPA provisions for terminating statutory hybrid plans (e.g., cash balance plans).

Background

On termination of a defined benefit plan, the Pension Benefit Guaranty Corporation (PBGC) must determine benefits for participants when it assumes trusteeship of a plan (under an involuntary or distress termination) or when it determines what benefits it will guarantee.

“Statutory hybrid plans” are a type of defined benefit plan, and they are defined under the Internal Revenue Code (Code) and regulations as plans that determine benefits either by reference to a hypothetical account balance or as an accumulated percentage of final average compensation (e.g., cash balance plans or pension equity plans). Determining benefits for terminating statutory hybrid plans presents unique difficulties because of the need to convert an account balance to an annuity or to derive a participant’s accrued benefit at normal retirement date from an account balance. These difficulties are compounded for plans that use a variable rate (e.g., a rate tied to a commercial index) to determine benefits.

The Pension Protection Act of 2006 (PPA) amended the Code and the Employee Retirement Income Security Act (ERISA) to provide new rules for determining benefits for terminating statutory hybrid plans. For example, PPA provided that where the interest crediting rate and/or the interest rate used in annuity conversions is a variable rate, a plan must use the average rate of interest over the five-year period before plan termination.

However, PPA did not address how the PBGC would determine benefits for terminating statutory hybrid plans when it assumes trusteeship or determines what benefits it will guarantee. For PBGC valuation and payment purposes, accrued benefits must be determined as of the plan termination date. Current PBGC regulations require the use of the actual interest rate in effect under the plan as of the plan termination date. However, for many statutory hybrid plans determining accrued benefits involves projecting interest credits to a participant’s normal retirement date. If such a plan uses a variable interest rate, the actual rate to be used is not known on the plan’s termination date. Because exact

benefits cannot be determined until a participant begins receiving payments, the PBGC has produced estimates of benefit amounts each year, which often differed from previously provided estimates or those that would have been calculated under the plan's terms.

In addition, the PBGC pays benefits in a single lump sum if that amount is *de minimis* (currently a value of \$5,000 or less). Most cash balance plans determine the lump sum amount as the hypothetical account balance. However, the PBGC generally projects the hypothetical account balance forward to normal retirement age, converts it to an annuity, and then determines the lump sum amount using the plan's conversion factors for lump sum payments. Projecting hypothetical account balances for plans using variable interest rates poses difficulties for the PBGC.

Proposed Regulations

The PBGC recently issued [proposed regulations](#) to amend its rules for terminating statutory hybrid plans. Comments are due December 30, 2011.

Variable Interest Rate

Under the proposed regulations, the PBGC generally will use the average interest rate mandated by the Code and ERISA, as amended by PPA. Specifically, if a plan provides for a fixed interest rate, the PBGC will use a fixed interest rate. If a plan provides for a variable interest rate, the PBGC will use the average interest rate over the five-year period before plan termination.

INSIGHT

Although the PBGC's use of the averaging method is not required by PPA, use of the method now required under the Code and ERISA will have the effect of aligning PBGC calculations with those of the plan.

If a plan terminates within five years of the PPA effective date, the PBGC will use the plan's pre-PPA interest rates in effect for the relevant period before the PPA effective date to determine the five-year average rate.

The proposed regulations further provide that where a plan has not been amended to conform to PPA provisions for terminating plans, the PBGC will nonetheless apply PPA's interest rate averaging rules to value benefits. If a plan does not specify the interest crediting rate or the annuity conversion interest rate, the PBGC will use the average of the 30-year Treasury Constant Maturity rate in effect for the calendar month of the plan termination and the rate in effect for the same calendar month in each of the previous four years.

Market Rate of Return

If the terminating plan's interest crediting rate either does not meet the PPA requirement not to exceed a market rate of return or is expressed as a function of the rate of return on plan assets, an annuity

contract rate, or the return for a registered investment company, the PBGC will replace the plan rate with the third segment rate (defined under Code Section 430(h)(2)) for the last month that precedes the beginning of an interest crediting period within the five-year averaging period.

INSIGHT

The Internal Revenue Service has not yet issued final regulations defining the “market rate of return,” so it may be difficult for the PBGC to assert that a plan does not meet this requirement.

De Minimis Lump Sums

With respect to determinations of small lump sums, the PBGC will use the account balance as of the plan’s termination date. In the case of a plan that does not value lump sums based on a participant’s account balance, the PBGC will value the benefit using whatever method the plan uses.

Mortality Basis

If the plan converts the account balance to an annuity using a mortality table that is automatically updated to reflect improvements in mortality (e.g., the applicable mortality table under Code Section 417(e)), the PBGC will take into account future adjustments to that table for expected improvements through a participant’s annuity starting date to determine both the accrued benefit at plan termination and the benefit payable under the automatic form of payment specified under the plan.

Conclusion

The PBGC proposed regulations provide certainty for terminating statutory hybrid plans and allow these plans to coordinate their calculations with those the PBGC will use. Buck’s consultants are available to help you understand these proposed regulations.