

EXPLANATION OF PEP PLAN ISSUES

Introduction

Pension Equity Plans (PEPs), or more properly PEP formulas, provide for a benefit defined as an accumulated percentage of pay. PEP formulas often closely resemble traditional defined benefit formulas except that a traditional benefit formula produces a benefit that is expressed as an annuity payable at normal retirement age (NRA) and a PEP formula produces a lump sum accumulated benefit that must be converted to an annuity payable at NRA. A PEP formula may be expressed in a number of ways, including:

- A fixed percentage of pay per year of service (such as 8% of final average compensation times years of service),
- A percentage of pay that increases based on the age or service of the employer (for instance, 5% of final average pay times service for the first 10 years and 6% of final average pay for each year of service over 10 years), or
- A percentage of pay that increases based on the number of “points” earned by the participant, where points are generally based on the sum of the participant’s age and service (for instance, 5% of final average pay times the number of years in which the participant has 0-50 points plus 6% of final average pay times the number of years in which the participant has over 50 points).

In addition, most PEP formulas include an interest component that is either explicit (interest is added to the accumulated benefit after accruals cease) or implicit (interest is included as part of a deferred to NRA annuity factor used to convert the accumulated benefit to an annuity payable at NRA).

This document is a line-by-line explanation of the questions on the Pension Equity Plan Determinations Worksheet. The Worksheet and this Explanation are intended for use by Employee Plans Determinations personnel reviewing pension equity plans. They primarily apply existing provisions of the Internal Revenue Code and published regulations as of the date of this document and are not intended to provide guidance. The Worksheet is divided into sections that deal separately with plans with explicit interest, plans with implicit interest and plans that do not include an interest component. Additional sections cover plans with multiple formulas, lump sum issues and hybrid plan conversions.

Note on deferred and immediate annuity factors: A deferred life annuity factor is used to determine the present value at the individual's current age, of a life annuity that begins at a later point in time. For example, if the participant is currently age 45 and the normal retirement age is 65, the deferred annuity factor would be used to determine the present value of a benefit that begins at 65, but discounted back to age 45 with interest and (usually) mortality. The discounting embedded in a deferred annuity factor has essentially the same impact on the accrued benefit as if interest (and mortality, if applicable) were credited on the participant’s lump sum benefit. In contrast, an immediate annuity factor is used to determine the present value of a benefit that begins

immediately at the stated age – for example a present value that is determined as of age 65 for a benefit that begins at age 65 is calculated using an immediate annuity factor. Therefore, if the participant's accumulated benefit under the PEP formula--without interest--is divided by the immediate annuity factor for a benefit payable at age 65 (regardless of the individual's current age), then the PEP formula defines a lump sum and an accrued benefit payable at age 65 and interest is not a factor.

Section I. Plans with Explicit Interest

A plan provides for explicit interest if it provides that interest is credited to the accumulated benefit after benefit accruals cease (such as upon termination of employment, transfer to a nonparticipating employer or division, or attainment of a maximum number of years of service or points). For example, a plan may provide that after a participant terminates employment with the plan sponsor, the accumulated benefit is credited with 4% interest for each year until the annuity starting date.

In order to avoid violating the accrual ("backloading") rules of section 411(b)(1) of the Internal Revenue Code ("Code") by having impermissibly backloaded benefit accruals when interest is credited at later ages, the plan must incorporate potential future interest credits into the accrued benefit determination in the same way as they would be included in a cash balance plan. (See Notice 96-8, 1996-1 C.B. 359, for a discussion of the principles involved.) Accordingly, the accrued benefit in this type of PEP is determined by:

- Calculating the accumulated benefit based on the participant's average pay and service as of the date of determination,
- Projecting interest to normal retirement age using the interest rate credited to the participant's accumulated benefit (or the rate that would have been credited, if the participant had terminated employment) at the date of determination, and
- Dividing the result by an immediate annuity factor at normal retirement age.

Line a. Section 411(a)(7)(A)(i) of the Code defines a participant's accrued benefit under a defined benefit plan as the employee's accrued benefit determined under the plan, expressed in the form of an annual (i.e., annuity) benefit commencing at normal retirement age. Section 1.411(a)-7(a) of the Income Tax Regulations (Regulations) provides that the accrued benefit of a participant under a defined benefit plan is either

- (a) the accrued benefit determined under the plan if the plan provides for an accrued benefit in the form of an annual benefit commencing at normal retirement age; or
- (b) the actuarial equivalent of the accrued benefit under the plan if the plan does not provide for an accrued benefit in the form of an annual benefit commencing at normal retirement age.

Since there is more than one for a plan to specify how the accrued benefit is determined, in order for the benefit to be definitely determinable, the plan must specify

how it determines the accrued benefit in the form of an annuity payable at normal retirement age.

If the plan does not provide for explicit interest credits, skip to section II.

Line b. Section 411(b) of the Code provides that a defined benefit plan must satisfy one of three accrual rules with respect to benefits accruing under the plan in order to prevent backloaded benefits—the 3 percent rule, the 133 1/3 percent rule or the fractional rule. Explicit interest PEPs rarely use the 3% rule so this worksheet focuses on the 133 1/3 percent rule and the fractional rule. Although some plan formulas are designed to satisfy one of the accrual rules and can be evaluated visually, most plans require accrual rule testing. Therefore, the plan should provide a demonstration or an explanation of how the pattern of accruals under the formula satisfies the 133 1/3 percent rule or the fractional rule. (See the explanation for lines c, d, and e for further details.)

Line c. Section 411(b)(1)(B) of the Code provides that a defined benefit plan satisfies the requirements of the 133 1/3 percent rule for a particular plan year if, under the plan, the accrued benefit payable at the normal retirement age is equal to the normal retirement benefit, and the annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age under the plan for any later plan year is not more than 133 1/3 percent of the annual rate at which he can accrue benefits for any plan year beginning on or after such particular plan year and before such later plan year. If the plan purports to satisfy the 133 1/3 percent rule and has provided a demonstration in line b, the demonstration must take into account the trade-off between PEP credits and the interest that would otherwise be credited if accruals had ceased. Note that it is more common for a PEP plan with increasing PEP credits to satisfy the fractional rule rather than the 133 1/3 percent rule.

As explained above under Line a, the accrued benefit for a PEP with explicit interest is determined by projecting interest to normal retirement age at the rate used to credit interest on the participant's accumulated benefit. As an example, consider a PEP formula that provides 6% of final average pay for the first 10 years of service and 8% of pay for each year of service over 10 years, and credits interest of 4% per year after the participant terminates employment. Assume for this example that the plan has a normal retirement age of 65 and that the immediate annuity factor at age 65 is 12.869.

Assume Participant P is age 45 with 10 years of service. P's accumulated benefit is 6% of final average pay times 10 years of service = 60% of final average pay. P's accrued benefit at age 45 (expressed as an annuity commencing at age 65) is 60% of final average pay, projected with 20 years of interest (to age 65) at 4% per year, divided by the immediate annuity factor at age 65:

At 45, P's accrued benefit = $60\% \times \text{pay} \times (1.04)^{20} \div 12.869 = 10.216\%$

The following year, when P is age 46 and has 11 years of service, P's accumulated benefit is 6% x 10 years of service plus 8% x 1 year of service = 68%. P is now one year older, so P's accrued benefit is determined projecting interest for only 19 years. Accordingly, P's accrued benefit at age 46 is 68% of final average pay, projected with 19 years of interest (to age 65) at 4% per year, divided by the immediate annuity factor at age 65:

At 46, P's accrued benefit = $68\% \times \text{pay} \times (1.04)^{19} \div 12.869 = 11.133\%$

P's accrual for the year is $11.133\% - 10.216\% = 0.917\%$ of final average pay. This reflects (1) the increase in P's accumulated benefit for an additional year of service, reduced by (2) the decrease in the expected number of years of projected interest. Any demonstration purporting to show that the plan complies with the backloading rules must test this net accrual – it is not appropriate to compare the 6% and 8% factors directly to test whether the plan complies with the backloading rules.

Line d. Section 411(b)(1)(C) of the Code provides that a defined benefit plan satisfies the requirements of the fractional rule if the accrued benefit to which a participant would be entitled if he separated from service upon the determination date is not less than:

- (1) The annual benefit commencing at normal retirement age to which he would be entitled under the plan as in effect on the determination date if he continued to earn annual PEP credits until normal retirement age, multiplied by
- (2) A fraction (not greater than 1), the numerator of which is the total number of the participant's years of participation in the plan as of the determination date, and the denominator of which is the number of years he would have participated in the plan if he separated from service at normal retirement age.

For the purpose of applying the fractional rule, the participant's benefit at normal retirement age is projected using the same rate of compensation upon which his normal retirement benefit would be computed under the plan, determined as if he had attained normal retirement age on the date any such determination is made (but taking into account no more than the 10 years of service immediately preceding the determination date).

One way that an explicit interest PEP may define the accrued benefit in order to satisfy the fractional rule is to specifically provide for a minimum fractional rule benefit. Such a plan provides that the accrued benefit is no less than the accumulated benefit projected with PEP credits (NOT interest) to NRA, converted to an annuity at NRA and multiplied by a fraction (no greater than 1), the numerator of which is the current number of a participant's years of service and the denominator of which is the number of years of service the participant will have earned upon attainment of NRA. This formula ensures that the plan satisfies the accrual rules regardless of the amount of interest credited, and a demonstration is not required. Alternatively, a PEP may demonstrate that the pattern of accruals under the formula satisfies the fractional rule (see explanation of line

e). It may be necessary to enlist the help of an actuary in evaluating the demonstration or explanation.

Line e. If the plan is not using fail-safe language to satisfy the fractional rule, as described above with respect to line d. the plan should provide a valid fractional rule demo that takes into account the interest rate trade-off between the PEP credits and the interest that would otherwise be credited if accruals ceased.

Line f. As noted above, in order to satisfy the accrual rules, an explicit interest PEP must take into account potential future interest as part of the accrued benefit. If the accrual rule demonstration relies on projecting interest at a particular interest rate to show that the plan satisfies an accrual rule, that interest rate must be specified in the plan as a minimum interest rate or a maximum interest rate in the plan, whichever applies.

Line g. In addition, a plan's interest crediting rate, including any minimum interest rate, must be no greater than a market rate of return as defined in section 411(b)(5)(B)(i)(III) of the Code. Whether or not a particular rate is not in excess of a market rate can be based on a reasonable interpretation until further guidance is issued. The rates described in proposed regulations published on October 19, 2010, are deemed to be reasonable pending final guidance, and other rates also may be considered reasonable. This rule is effective:

- For plan years beginning on or after January 1, 2008, if a plan was in existence as a hybrid plan on June 29, 2005, or
- The later of June 29, 2005, or the date the plan became a statutory hybrid plan (i.e., a PEP or cash balance plan), for plans not in existence as hybrid plans on June 29, 2005.

Line h. Section 411(b)(1)(G) of the Code provides that a plan fails to satisfy the accrued benefit rules if a participant's accrued benefit is reduced on account of any increase in his age or service. As shown in the explanation to line c, fewer years of interest are projected to NRA as a participant ages. Thus, a plan violates section 411(b)(1)(G) of the Code unless the additional PEP credits for the year offset the loss of a year of future interest (the "trade-off" between gaining an additional PEP credit and losing a year of interest). Specifically, the accrual in any given year that is considered under section 411(b)(1)(G) is (1) the increase in the PEP formula due to the accrual of additional PEP credits minus (2) one year's interest on the PEP accumulated benefit as of the end of the prior year (because interest is not credited if the participant continues to accrue benefits). In any year that item (2) is larger than item (1), there is an impermissible reduction in the participant's accrued benefit.

Note that section 411(b)(1)(G) of the Code does not preclude an increase or decrease in the dollar amount of a participant's benefit due to fluctuations in the participant's final average compensation, the rate used to project interest, or in the rates used to determine the annuity conversion factor.

To guard against a violation of section 411(b)(1)(G) of the Code, a PEP must contain language that ensures compliance with section 411(b)(1)(G) of the Code. Pending the issuance of guidance that will provide for more specific ways of complying with the provision, there are a number of ways that a plan may include acceptable language in the plan document. For example a plan may provide that:

- Notwithstanding any other provision in the plan, a participant's accrued benefit as of any determination date will never be less than the benefit required to comply with IRC 411(b)(1)(G).
- Notwithstanding any other provision in the plan, a participant's accrued benefit may not be reduced on account of an increase in a participant's age or service.
- A participant's accrued benefit as of any determination date shall not be less than the accrued benefit to which the participant would have been entitled if he had ceased accruals at the end of any prior plan year.
- A participant's accrued benefit shall be the lesser of the annuity benefit that the participant has accumulated to date (including projected interest to NRA) and the annuity benefit the participant would accumulate if he worked to NRA.
- The accumulated benefit determined under the PEP formula as of any determination date cannot be less than the accumulated benefit as of the end of any prior year with interest credited to the determination date, determined as if the participant had ceased accruals as of the end of that prior plan year.

Note that while most of these provisions can be added retroactively, a plan generally cannot be amended to apply the "lesser of" formula to benefits already accrued, because such an amendment could cause a reduction in the accrued benefit in violation of Code section 411(d)(6).

Section II. Plans with Implicit Interest

An implicit interest PEP does not provide that interest is credited to the accumulated benefit after benefit accruals cease, but instead determines the accrued benefit as an annuity commencing at NRA by dividing the accumulated benefit by a deferred annuity factor. This has the same effect as projecting interest to NRA using the interest rate (and mortality rates, if applicable) embedded in the deferred annuity factor.

In some cases, it may not be possible to distinguish a plan that provides for implicit interest from a no-interest plan, described in Section III. In such cases, it may be necessary to request sample accrued benefit calculations for participants who are under normal retirement age to determine whether the plan is using a deferred annuity factor, and the plan language should then be clarified to reflect the approach used under the plan. The younger the age of the participants in the sample calculations, the easier it will be to determine whether the annuity factor is a deferred annuity factor.

Dividing the accumulated benefit by a deferred annuity factor has the effect of providing interest on the accumulated benefit to NRA. Therefore, using the deferred annuity factor automatically incorporates interest into the accrued benefit determination.

Line a. Section 411(a)(7)(A)(i) of the Code defines a participant's accrued benefit under a defined benefit plan as the employee's accrued benefit determined under the plan, expressed in the form of an annual benefit commencing at normal retirement age. Section 1.411(a)-7(a) of the Regulations provides that the accrued benefit of a participant under a defined benefit plan is either

- (a) the accrued benefit determined under the plan if the plan provides for an accrued benefit in the form of an annual benefit commencing at normal retirement age; or
- (b) the actuarial equivalent of the accrued benefit under the plan if the plan does not provide for an accrued benefit in the form of an annual benefit commencing at normal retirement age.

Since there is more than one way for a plan to specify how the accrued benefit is determined, in order for the benefit to be definitely determinable, the plan must specify how it is determining the accrued benefit in the form of an annuity payable at normal retirement age.

If the plan does not provide for interest in any way, skip to section III.

Line b. Section 411(b) of the Code provides that a defined benefit plan must satisfy one of three accrual rules with respect to benefits accruing under the plan in order to prevent backloaded benefits—the 3 percent rule, the 133 1/3 percent rule or the fractional rule. Implicit interest PEPs rarely use the 3% rule so this worksheet focuses on the 133 1/3 percent rule and the fractional rule. Although some plan formulas are designed to satisfy one of the accrual rules and can be evaluated visually, most plans require accrual rule testing. Therefore, the plan should provide a demonstration or an explanation of how it satisfies the 133 1/3 percent rule or the fractional rule. (See the explanation for lines c, d, and e for further details.)

Line c. Section 411(b)(1)(B) of the Code provides that a defined benefit plan satisfies the requirements of the 133 1/3% rule for a particular plan year if, under the plan, the accrued benefit payable at normal retirement age is equal to the normal retirement benefit, and the annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age under the plan for any later plan year is not more than 133 1/3% of the annual rate at which he can accrue benefits for any plan year beginning on or after such particular plan year and before such later plan year. If the plan purports to satisfy the 133 1/3 percent rule and has provided a demonstration in line b, the demonstration must take into account the trade-off between PEP credits and the increase in the deferred annuity factor from year to year. Note that it is more common for a PEP plan with increasing PEP credits to satisfy the fractional rule rather than the 133 1/3 percent rule.

As explained under line a, the accrued benefit for a PEP with implicit interest is determined by dividing the accumulated benefit by a deferred annuity factor. As an example, consider a PEP formula that provides 6% of final average pay for the first 10

years of service and 8% of pay for each year of service over 10 years. Assume the plan has a normal retirement age of 65, and defines the accrued benefit using a deferred-to-65 annuity based on 4% interest and the mortality table in Revenue Ruling 2001-62. Assume for this example that the deferred annuity factor is 5.422 for a 45-year-old participant and 5.645 for a 46-year-old participant.

Assume Participant P is age 45 with 10 years of service. P's accumulated benefit is 6% of final average pay times 10 years of service = 60% of final average pay. P's accrued benefit is 60% of pay divided by the deferred annuity factor under the plan for a 45-year-old participant (based on the plan's definition of actuarial equivalence). No interest is credited on P's accumulated benefit, and no interest is projected to normal retirement because interest and mortality are built into the deferred annuity factor.

At 45, P's accrued benefit = $60\% \times \text{pay} \div 5.422 = 11.066\%$

The following year, when P is age 46 and has 11 years of service, P's accumulated benefit is 6% x 10 years of service plus 8% x 1 year of service = 68%. P's accrued benefit at age 46 is 68% of final average pay divided by the deferred annuity factor for a 46-year-old participant.

At 46, P's accrued benefit = $68\% \times \text{pay} \div 5.645 = 12.046\%$

P's accrual for the year is $12.046\% - 11.066\% = 0.980\%$ of final average pay. This reflects (1) the increase in P's accumulated benefit for an additional year of service, (2) reduced to reflect the change in the deferred annuity factor because the participant is one year closer to normal retirement age. Any demonstration purporting to show that the plan complies with the backloading rules must test this net accrual – it is not appropriate to compare the 6% and 8% factors directly to test whether the plan complies with the backloading rules.

Line d. Section 411(b)(1)(C) of the Code provides that a defined benefit plan satisfies the requirements of the fractional rule if the accrued benefit to which a participant would be entitled if he separated from service upon the determination date is not less than:

- (1) The annual benefit commencing at normal retirement age to which he would be entitled under the plan as in effect on the determination date if he continued to earn annual PEP credits until normal retirement age, multiplied by
- (2) A fraction (not greater than 1), the numerator of which is the total number of the participant's years of participation in the plan as of the determination date, and the denominator of which is the number of years he would have participated in the plan if he separated from service at normal retirement age.

For the purpose of applying the fractional rule, the participant's benefit at normal retirement age is projected using the same rate of compensation upon which his normal retirement benefit would be computed under the plan, determined as if he had attained normal retirement age on the date any such determination is made (but taking into

account no more than the 10 years of service immediately preceding the determination date).

One way that an implicit interest PEP may define the accrued benefit in order to satisfy the fractional rule is to specifically provide for a minimum fractional rule benefit. Such a plan provides that the accrued benefit is no less than the accumulated benefit projected with PEP credits (NOT interest) to NRA, converted to an annuity at NRA and multiplied by a fraction (no greater than one), the numerator of which is the current number of a participant's years of service and the denominator of which is the number of years of service the participant will have earned upon attainment of NRA. This formula ensures that the plan satisfies the accrual rules regardless of the rate of interest and mortality assumption included in the annuity factor and a demonstration is not required. Alternatively, a PEP may demonstrate that the pattern of accruals under the formula satisfies the fractional rule (see explanation of line e). It may be necessary to enlist the help of an actuary in evaluating the demonstration or explanation.

Line e. If the plan is not using fail-safe language to satisfy the fractional rule, as described above with respect to line d. the plan should provide a valid fractional rule demo that takes into account the interest rate trade-off between the PEP credits and the change in the value of the deferred annuity factor during each year.

Line f. As noted above, in order to satisfy the accrual rules an implicit interest PEP must take into account the future interest (and mortality, if applicable) as part of the accrued benefit. If the PEP credit formula is a steeply graded formula, it may need to provide for a minimum (or maximum) interest rate to determine the deferred annuity factor to satisfy one of the accrual rules, and the plan must then explicitly provide for such interest rate.

Line g. If a participant terminates employment or otherwise ceases accruals and does not take a distribution, the deferred annuity factor used to determine the participant's future benefit must be based on the participant's age on the date accruals cease (but using the plan's interest and mortality rates as of the annuity starting date). Using a different annuity factor based on a later age results in an accrued benefit that decreases with each successive year of age, in violation of section 411(b)(1)(G) of the Code.

Line h. Section 411(b)(1)(G) of the Code provides that a plan fails to satisfy the accrued benefit rules if a participant's accrued benefit is reduced on account of any increase in his age or service. As shown in the explanation to line c, the interest component of the deferred annuity factor used to determine the accrued benefit decreases with each additional year that a participant accrues benefits. Thus, a plan violates section 411(b)(1)(G) of the Code unless the additional PEP credits for the year offset the loss of a year of future interest (the "trade-off" between gaining an additional PEP credit and losing a year of interest). Specifically, the accrual in any given year that is considered under section 411(b)(1)(G) is (1) the increase in the PEP formula due to the accrual of additional PEP credits offset by (2) one year's interest (based on the deferred annuity factor) not taken into account because the participant continued to

work an additional year and the factor therefore takes one less year into consideration. In any year that item (2) is larger than item (1), there would be an impermissible reduction in the participant's accrued benefit.

Note that section 411(b)(1)(G) of the Code does not preclude an increase or decrease in the dollar amount of a participant's benefit due to fluctuations in the participant's final average compensation or in the rates used to determine the annuity conversion factors.

To guard against a violation of section 411(b)(1)(G) of the Code, a PEP must contain language that ensures compliance with section 411(b)(1)(G) of the Code. Pending the issuance of guidance that will provide for more specific ways of complying with the provision, there are a number of ways that a plan may include acceptable language in the plan document. For example a plan may provide that:

- Notwithstanding any other provision in the plan, a participant's accrued benefit as of any determination date will never be less than the benefit required to comply with IRC 411(b)(1)(G).
- Notwithstanding any other provision in the plan, a participant's accrued benefit may not be reduced on account of an increase in a participant's age or service.
- A participant's accrued benefit as of any determination date shall not be less than the accrued benefit to which the participant would have been entitled if he had ceased accruals at the end of any prior plan year.
- A participant's accrued benefit shall be the lesser of the annuity benefit that the participant has earned to date (including interest (and mortality, if applicable), reflected in the deferred annuity factor) and the benefit the participant would earn if he worked to NRA and accumulated the full number of PEP credits.

Note that while most of these provisions can be added retroactively, a plan generally cannot be amended to apply the "lesser of" formula to benefits already accrued, because such an amendment could cause a reduction in the accrued benefit in violation of Code section 411(d)(6).

Section III. No-Interest PEPs

A plan is a no-interest PEP if it does not provide for interest either by crediting interest on the accumulated benefit after cessation of accruals, or by using a deferred annuity factor to determine the accrued benefit. Under a no-interest PEP formula the accrued benefit is equal to an annuity at NRA determined by dividing the accumulated benefit (with no projection for interest) by an immediate annuity factor at normal retirement age. A stable value plan is a type of no-interest PEP.

In some cases, it may not be possible to distinguish a plan that provides for implicit interest from a no-interest plan. In such cases, it may be necessary to request sample accrued benefit calculations for participants who are under normal retirement age, to determine whether the plan is using a deferred annuity factor, and the plan language should then be clarified to reflect the approach used under the plan. The younger the

age of the participants in the sample calculations, the easier it will be to determine whether the annuity factor is a deferred annuity factor.

Because the no-interest PEP does not have an interest component, the issues that involve interest do not apply to no-interest PEPs, such as the need for a minimum (or maximum) interest rate, the need to project the accrued benefit to NRA, and the potential violation of section 411(b)(1)(G) of the Code caused by the trade-off between PEP credits and interest.

Line a. Although a no-interest PEP has a formula based on an accumulated percentage of pay without future interest, it still must define the accrued benefit in terms of an annuity at NRA. Thus, no-interest PEPs generally must define the accrued benefit as the accumulated benefit divided by an immediate annuity factor at NRA.

Line b. Section 411(b) of the Code provides that a defined benefit plan must satisfy one of the three accrual rules with respect to benefits accruing under the plan in order to prevent backloaded benefits—the 3 percent rule, the 133 1/3 percent rule or the fractional rule. Because a no-interest PEP does not have future interest accruals to take into account, the analysis for whether a no-interest PEP satisfies the accrual rules is the same as for a traditional defined benefit plan.

As explained under line a, the accrued benefit for a PEP that does not provide for interest is determined by dividing the accumulated benefit by an immediate annuity factor at normal retirement age, even if the participant has not yet reached normal retirement age. As an example, consider a PEP formula that provides 6% of final average pay for the first 10 years of service and 8% of pay for each year of service over 10 years. Assume for this example that the plan has a normal retirement age of 65 and that the immediate annuity factor at age 65 is 12.869.

Assume Participant P is age 45 with 10 years of service. P's accumulated benefit is 6% of final average pay times 10 years of service = 60% of final average pay. P's accrued benefit is 60% of pay divided by the immediate annuity factor under the plan for a 65-year-old participant (even though P is only 45 years old). No interest is credited on P's accumulated benefit, and no interest is projected to normal retirement because this plan does not provide for interest.

At 45, P's accrued benefit = $60\% \times \text{pay} \div 12.869 = 4.662\%$

The following year, when P is age 46 and has 11 years of service, P's accumulated benefit is 6% x 10 years of service plus 8% x 1 year of service = 68%. P's accrued benefit at age 46 is 68% of final average pay divided by the immediate annuity factor for a 65-year-old participant.

At 46, P's accrued benefit = $68\% \times \text{pay} \div 12.869 = 5.284\%$

P's accrual for the year is $5.284\% - 4.662\% = 0.622\%$ of final average pay. This reflects the increase in P's accumulated benefit for an additional year of service based on the plan's formula, converted to an annuity benefit beginning at age 65 (i.e., normal retirement age). Because no interest is involved for the period between P's current age and age 65, a PEP formula that does not provide for interest (either explicitly or implicitly) can be tested for compliance with the backloading rules comparing the 6% and 8% factors using the same approaches used for traditional plans.

Section IV. Plans with Multiple Formulas

Some PEP plans define the accrued benefit using a combination of formulas. For example, a plan could provide that the accrued benefit is based on the greater of a PEP formula and a traditional defined benefit formula. In analyzing this type of formula for compliance with the accrual rules, as long as each component of the formula satisfies the fractional rule, the "greater of" formula will also satisfy the fractional rule. This type of formula typically would not satisfy the 133 1/3 percent rule, however, because there is a possibility that the determination of the accrued benefit would "cross" between the component formulas, producing a very low accrual in the crossing year that would not support later higher accrual rates. Revenue Ruling 2008-7 provided limited relief for certain "greater of" formulas for years beginning before January 1, 2009. Section 1.411(b)-1(b)(2)(ii)(G) of the proposed regulations provides that for years beginning on or after January 1, 2009, a plan with multiple formulas may satisfy the accrual rules by demonstrating that each separate formula satisfies the requirements of the 133 1/3% rule, provided that each separate formula uses a different basis for determining benefits.

Line a. Section 1.411(b)-1(a) of the Regulations provides that a plan may provide that accrued benefits for participants are determined under more than one formula and that, in that case, the accrued benefits under all such formulas must be aggregated in order to determine whether or not the accrued benefits under the plan satisfy one of the accrual methods. In order to be definitely determinable and satisfy the accrual rules with respect to the accrued benefit, a plan that has multiple formulas must provide that all of the formulas are taken into account in determining the accrued benefit. These might take the form of a "greater of," a "lesser of," or a "sum of" formula. The rule varies depending on whether the plan is being tested for plan years before or after 2009.

Line b. Revenue Ruling 2008-7, 2008-7 I.R.B. 419 ("Rev. Rul. 2008-7") describes a traditional defined benefit pension plan that is amended in 2001 to convert a traditional defined benefit formula to a cash balance formula for plan years beginning on or after January 1, 2002. Rev. Rul. 2008-7 emphasizes that at least one of the three accrual rules, i.e., sections 411(b)(1)(A), (B), or (C) of the Code must be satisfied with respect to all participants. Moreover, Rev. Rul. 2008-7 explains that, if the benefits of all participants do not satisfy the same accrual test, the plan is permitted to satisfy one of the accrual rules for some participants and another accrual rule for other participants as long as the structure of classification of participants is not to evade the accrued benefit requirements of sections 411(b)(1)(A), (B), and (C) of the Code. In addition, Rev. Rul. 2008-7 provides relief under section 7805(b) of the Code for certain plans, including

“moratorium plans.” Under this relief, for plan years beginning before January 1, 2009, the Service will not treat such a plan as failing to satisfy the accrual rules under sections 411(b)(1)(A), (B), and (C) of the Code solely because the plan provides a “greater of” benefit, where each of the separate formulas, standing alone, would satisfy one of the accrual rules.

Line c. In the absence of further guidance, a PEP may demonstrate compliance with the accrual rules with respect to multiple formulas on the basis of reasonable interpretation.

Section V. Compliance with Code Section 417(e)(3) Requirements

Prior to enactment of the Pension Protection Act of 2006 (“PPA”), a PEP could not pay a lump sum equal to the accumulated benefit unless the amount of the accumulated benefit was at least as large as the present value of the accrued benefit calculated according to section 417(e)(3) of the Code. However, Notice 96-8, 1996-1 CB 359, provided that if a cash balance plan (or other hybrid plan) used one of several listed safe harbor interest rates to credit interest, the plan could pay lump sums equal to the account balance (or accumulated benefit). Section 411(a)(13) of the Code, as added by PPA, generally permits PEPs to pay lump sums equal to the accumulated benefit under the PEP formula. Section 411(a)(13) of the Code only applies to benefits payable under a lump-sum based formula. Note that section 411(a)(13) of the Code also provides relief for other forms of payment that would otherwise be subject to section 417(e)(3) of the Code.

Line a. If the PEP does not provide for lump sum distributions, this section of the worksheet does not apply.

Line b. Section 417(e)(3) of the Code provides that a lump sum payment under a qualified plan may not be less than the present value of the participant’s accrued benefit calculated using the applicable mortality table and the applicable interest rate. For lump sum distributions prior to August 17, 2006, Notice 96-8 provided safe harbor interest rates, which, if used by a cash balance plan (or other hybrid plan) to credit interest, would allow the plan to pay lump sums equal to the account balance (or accumulated benefit). Plans not using safe harbor rates, therefore must define the lump sum to be no less than the present value of the accrued benefit (expressed as an annuity commencing at normal retirement age) using 417(e) assumptions. To the extent that an implicit interest PEP reflects preretirement mortality it will be considered not to have a safe harbor interest rate and must contain language to comply with section 417(e)(3) of the Code.

Line c. Effective for lump sum distributions with initial annuity starting dates on or after August 17, 2006 (but before the effective date of the final regulations), PPA permits a PEP to provide that the present value of the accrued benefit derived from the PEP formula is equal to the accumulated benefit, thus allowing lump sum payments under the PEP formula to be equal to the accumulated benefit regardless of the interest rate

used to calculate the accrued benefit. If the plan previously provided for lump sums based on the rules of section 417(e)(3) of the Code, section 1107 of PPA permitted plans to be amended to reflect the PPA provisions instead – but only if the amendment was adopted by the end of the plan year beginning in 2009. Amendments made after that date must provide protection for benefits accrued prior to the date of the amendment as required under section 411(d)(6) of the Code.

Line d. If a PEP plan contains multiple formulas under which the benefit may be determined, and at least one of the formulas is not a hybrid formula, to the extent that the benefit is attributable to any non-hybrid formula, the rules of section 417(e)(3) of the Code will apply to the determination of the lump sum under the non-hybrid formula. Reasonable interpretation may be used to determine how to compare the hybrid and non-hybrid formula benefits when calculating the lump sum payable from the plan.

Section VI. Hybrid Plan Conversions

A hybrid plan conversion occurs when a hybrid plan formula is adopted (e.g., a PEP formula) and future benefit accruals under the traditional defined benefit formula are reduced or eliminated. Prior to June 29, 2005, the main concern was avoiding cutback or elimination of benefits as a result of a plan amendment in violation of section 411(d)(6) of the Code. PPA established additional rules that apply for conversions on or after June 29, 2005.

Line a. For conversions on or before June 29, 2005, in order to avoid a reduction in a participant's benefit as a result of the conversion amendment, the plan must provide that in no event will the accrued benefit be less than it was immediately prior to the conversion date. This can be accomplished through one of two techniques.

- Under “wearaway,” the plan provides that the accrued benefit is the greater of the benefit derived under the prior traditional formula immediately prior to the conversion date and the benefit derived under the PEP formula.
- Under “A+B,” the plan provides that the accrued benefit is the sum of the benefit derived under the prior formula immediately prior to the conversion date (the “A” portion) and the benefit derived under the PEP formula (the “B” portion).

If there are more than two formulas under the plan, the definition of accrued benefit should take into account all of the formulas under the plan. The PEP formula may include an “opening” accumulated benefit based on the present value of the prior benefit or based on pre-amendment years of service, however, the inclusion of such an opening amount cannot take the place of providing that the accrued benefit under the plan cannot be less than the accrued benefit as of the date before the conversion.

Line b. For plans converted after June 29, 2005, sections 411(b)(5)(B)(ii) and (ii) of the Code provide that an applicable defined benefit plan is age discriminatory unless, with respect to each individual who was a participant in the plan prior to the conversion amendment, the accrued benefit of such participant is not less than the sum of (1) the participant's accrued benefit for years of service before the date of the amendment,

determined under the terms of the plan in effect before the amendment and (2) the participant's accrued benefit for years of service after the date of the amendment determined under the terms of the plan in effect after the amendment. Thus, a plan that is amended to convert to a PEP formula after June 29, 2005 must provide that the accrued benefit is the sum of the benefit derived under the prior formula and the benefit derived under the PEP formula (i.e., "A plus B"). A plan that provides this will automatically avoid a reduction in a participant's benefit as a result of the conversion amendment. In addition, if there are more than two formulas under the plan, the definition of accrued benefit should take into account all of the formulas under the plan.

Section VII. Eligibility for IRC 7805(b) Relief

A plan that received a prior favorable determination letter that covered its PEP provisions may be entitled to relief under section 7805(b) of the Code, which limits the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied retroactively. Accordingly, an administrative decision to revoke a prior favorable determination letter is not applied retroactively if (1) there has been no misstatement or omission of material facts; (2) the facts at the time of the transaction are not materially different from the facts on which the letter ruling or TAM or determination letter was based; (3) there has been no change in the applicable law; (4) in the case of a letter ruling or determination letter, it was originally issued on a prospective or proposed transaction; and, (5) the taxpayer directly involved in the letter ruling or TAM or determination letter acted in good faith in relying on the letter ruling or TAM or determination letter, and the retroactive modification or revocation would be to the taxpayer's detriment. In order to receive relief, generally technical advice must be requested. If the relief is granted, the taxpayer generally is not required to make retroactive plan corrections in order to remain qualified, although the retroactive correction may be necessary to avoid liability under Title I of ERISA.

Line a. Does the plan have a prior favorable determination letter that covers the PEP plan provisions? If so, note the date in the comments section of the worksheet.

Line b. If the plan has a favorable determination letter covering the PEP plan provisions, are the current provisions substantially similar to the ones approved in the determination letter? If so the plan may be eligible for relief for past years and need only make prospective corrections.