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Hybrid Plan Regulations Relax Market Rate of Return

Final hybrid plan regulations from IRS fill in most gaps in previously finalized rules addressing the changes for these plans introduced by the Pension Protection Act of 2006. In addition to the anticipated interest crediting "market rate of return" cap, the regulations cover an assortment of details that may require amendments by sponsors of hybrid plans in advance of the January 1, 2016 effective date (calendar year plans). Proposed regulations address how plans may be amended if they have interest crediting rates that will not be permitted under the final rule.

Background

Traditional pension plan design aims to define an annuity benefit payable upon retirement based on a participant's compensation and years of service. In response to the apparent preference of plan participants for benefits expressed in defined contribution form, cash balance and other hybrid structures emerged to give the look and feel of defined contribution plans, allocate risk between the employer and employees while limiting volatility, and yet retain the ability to deliver benefits in annuity form and provide other ancillary benefits and subsidies. Because these plans were indeed defined benefit plans, the application of some qualification and ERISA requirements to such plans made it difficult to get an IRS determination letter for a time, and led to employee challenges in court, especially about alleged age discrimination.

"Whipsaw"

Cash balance whipsaw refers to the problem that occurs when the hybrid plan is forced to project the current account to normal retirement age, convert to a life annuity form, and then value that benefit using the mandated rates in IRC 417(e). If the interest and mortality basis for the projection is richer than the 417(e) basis, the resulting lump sum will be bigger than the cash balance account.

The Pension Protection Act of 2006 (PPA) ushered in new rules for cash balance and other hybrid plans to resolve technical issues and clear the way for these nontraditional designs. PPA excused these plans, if properly designed, from the historical minimum present value requirement that had created so-called "whipsaw," imposed a three-year vesting requirement, and added specific rules aimed at preventing age discrimination.

In 2010, IRS and Treasury finalized a portion of the guidance needed for implementing the PPA changes and proposed additional regulations dealing with remaining difficult topics, such as the requirement to limit interest credits to no more than a market rate of return. Details on the 2010 final and proposed regulations were provided in our November 15, 2010 *For Your Information*.

2014 Additional Final Regulations – Effective Date

The long-awaited additional final hybrid plan regulations are generally effective for plan years that begin on or after January 1, 2016; previously finalized regulations, other than the market rate of return requirements, remain effective for plan years beginning on or after January 1, 2011. The market rate of return requirements enjoy the 2016 compliance deadline. Plan sponsors can rely on prior guidance to demonstrate compliance with the PPA legal standard. On questions not covered by prior guidance, plan sponsors must be able to defend their plan design based on a reasonable interpretation of PPA. Plan sponsors are welcome to adopt any of the regulatory options earlier than required.

> **Comment.** Plan sponsors will need to be mindful of the funding based restrictions on amending plans when evaluating the regulatory options offered by the hybrid regulations. Amendments to meet mandatory vesting requirements — which would include the market rate of return requirement — are excused from this funding-based restriction, but only to the extent the increase is necessary to continue to satisfy plan qualification requirements. Opting to increase a market rate of return floor to a greater level than currently provided will need to be evaluated by the plan's actuary.

Market Rate of Return Changes

These new final regulations settle a number of open issues about the options available to a cash balance plan sponsor for setting the amount of interest rate credit that will be provided by the plan. Under the final regulations, for plans providing a single fixed interest rate, the rate can be as high as 6% instead of the 5% rate allowed by the proposed regulations. For plans crediting a government bond or CPI variable rate (with or without the additional margins allowed by Notice 96-8) and providing a fixed interest rate floor, the floor rate can now be as high as 5% annually instead of the 4% rate in the proposed regulations. The 4% floor is retained for plans using segment rates as the basis for their interest crediting rate. All plans are permitted to provide a cumulative floor at benefit commencement, not to exceed compound interest at 3% per year.

Participant Choice of Interest Crediting Rate "on Ice"

Plan designs that include participant self-direction of investments for determining interest credits are "under further study." IRS had asked for comments on whether a statutory hybrid plan should be permitted to allow this feature. In light of qualification concerns, limited participant investment capabilities, lack of the ERISA 404(c) shield for fiduciaries in the defined benefit context, and possible anti-cutback limitations when participants change investment selections, the IRS was not prepared to adopt current regulations banning or enabling this design.

If future regulations were to ban or otherwise limit the use of this feature, IRS warns that any anti-cutback relief for plans using this approach will be limited to those that had already adopted and implemented these provisions by September 18, 2014.

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Permitted Maximum Interest Crediting Rates

The following table summarizes the various annual interest crediting rate options available going forward under the revised final regulations. IRS rejected requests that other market rates be permitted in addition to the rates specified in the final regulations on the grounds that it would not be administratively feasible for them to evaluate other rates to assess compliance. Thus, these are the only rates that are permitted to be used. However, there is flexibility in applying the rates in that the plan is not forced to use a single uniform rate for all participants — different rates may be specified for different groups within the plan (in a nondiscriminatory fashion). In addition, different rates may be applied to predetermined portions of a participant's benefit.

Type of Rate	Value/Conditions	Margin/Adjustment	Permitted Floor*
Fixed	Up to 6%	N/A	N/A
Bond Index	Discount rate on 3-month Treasury Bills	Up to175 basis points	Up to 5%
	Discount rate on 12-month or shorter Treasury Bills	Up to150 basis points	Up to 5%
	Yield on 1-year Treasury Constant Maturities	Up to100 basis points	Up to 5%
	Yield on 3-year or shorter Treasury Constant Maturities	Up to 50 basis points	Up to 5%
	Yield on 7-year or shorter Treasury Constant Maturities	Up to 25 basis points	Up to 5%
	Yield on 30-year or shorter Treasury Constant Maturities	0 basis points	Up to 5%
Segment Rate	417(e) First, second, or third segment rate	N/A	Up to 4%
	430(h) First, second, or third segment rate	With or without interest rate stabilization	Up to 4%
CPI	BLS "all items" rate for population or geographic population (can be capped)	Up to 300 basis points	Up to 5%
Actual Plan Assets Rate	Actual return on all or subset of, plan assets. Must be diversified; subset approximates associated liabilities and limits employer securities/real estate to 10%	N/A	N/A
Annuity Contract Rate	Rate in contract by state-licensed insurer	N/A	N/A
Regulated Investment Company (RIC)	Rate of return based on broad US or international equities market fund	N/A	N/A
Participant Choice	No anti-cutback relief for post September 18, 2014 implementations if future final rules require changes	N/A	N/A
Other Rates Published by Commissioner	As announced	As announced	As announced
* Or, a cumulative floor at benefit commencement, based on annual rate up to 3%. All plans must have a cumulative floor at benefit commencement of at least 0%.			

Comment. Many cash balance plans increase pay credits as age and/or service increases. To pass rules against "backloading" benefit accrual, these plans have typically had to guarantee a minimum interest credit of 5% per year. The new final regulations, by increasing the allowable minimum interest from 4% to 5% for plans that use one of the bond indexes, have allowed many, perhaps most, cash balance plans to continue to operate after 2015 without significant design changes.

Lump Sum Must Match Current Balance

A hybrid plan seeking to obtain the PPA shelter from whipsaw must express benefits using a lump sum-based formula such as the current balance of a hypothetical account (cash balance) or the current value of an accumulated percentage of final average pay (PEP). Under the final regulations, if a lump sum distribution is offered as an option under the terms of the plan, the lump sum must at least equal the accumulated benefit under the hybrid plan formula. The plan is not required to offer a lump sum payment.

In addition, the portion of the accrued benefit determined by the accumulation must be either the actuarial equivalent of the accumulation upon attainment of normal retirement age or at the annuity starting date.

Distribution Year Adjustments

The final regulations retain the rule from the proposed regulations that allowed flexibility in applying the plan's interest crediting rate for the year of distribution. The plan is not required to credit interest for the period from the end of the last interest crediting period to the date of distribution. But such interest may be credited, and interest may be allocated on additional pay credits during that period.

Opening Balance Options for Conversions

Given the choice, most plan sponsors who are converting from a traditional to a cash balance formula would prefer to set up an initial account balance reflecting their traditional formula and just move forward with pay and interest credits. But variations in actuarial factors and age discrimination concerns prevent this from being a smooth transaction. For example, using the value of the benefit at a current age with early retirement subsidies included would forever imbed those subsidies in the participant's account — and younger participants would enjoy the value of a benefit (that is, the early retirement subsidy) that older participants would not receive.

The result is that plan sponsors can either leave the traditional piece in its traditional form, or the benefit can be converted to an opening account value — without including early retirement subsidies — and tested at the participant's distribution date to confirm the accrued benefit at conversion, with its associated option and early retirement factors, is appropriately grandfathered.

The IRS had considered a partial "set it and forget it" approach to creating an opening balance that would have been available in certain circumstances. Under this approach, the plan would have determined an opening balance that is the actuarial equivalent of the current accrued benefit at the time of conversion and would not have needed to compare old and new benefits at distribution for certain benefit forms. This was abandoned in response to comments complaining that it was complex and might not guarantee the proper amount of pre-conversion benefit. Plan sponsors who had adopted this approach in reliance on the proposed regulations will be required to implement the more restrictive final regulations approach by no later than the effective date. They will not have the option of retaining the approach in the proposed regulations after that date, but are not required to revise distributions processed during the intervening period.

Optional Form Rules

Plans can obtain the PPA relief from whipsaw even if subsidized early retirement or other optional forms of payment are provided, but not if such benefits are less than the benefit that is actuarially equivalent to the account balance using "reasonable actuarial assumptions"— an undefined term. In the latter situation, for example, the IRC 417(e) minimum present value rates would need to be used for lump sums, period certain annuities, and Social Security level income options.

> **Comment.** The proposed regulations had allowed for optional forms that were actuarially equivalent to the annuity benefit determined by the cash balance account. Thus, it appeared that different factors could be used to calculate the optional forms of annuity payments than were used for the automatic forms of annuity payments. The final regulations call for all options to be determined as the equivalent of the then-current hypothetical account (or, for Pension Equity Plans, the accumulated percentage of final average compensation).

Accrual Rules and Post Normal Retirement Date Actuarial Increases

Although hybrid plans may mimic defined contribution plans in many ways, they are nonetheless defined benefit plans and subject to defined benefit plan qualification requirements. The final regulations underscore this point with an amendment to the backloading regulation that allows plans to comply by assuming future interest credits will not be less than zero even when using a variable rate that actually did produce a negative interest credit for the prior year. Rules for multiple formulas under the backloading regulation remain "reserved."

The final PPA regulations also focus on protecting the benefit after normal retirement age from forfeiture through the operation of insufficient actuarial adjustments — a requirement applicable to all defined benefit plans. As with any defined benefit plan, forfeiture is permitted under the suspension of benefit rules if proper notice is provided. Minimum distribution rules override this forfeiture if the participant continues in service after the April 1 after reaching age 70 ½. For plans that do not "suspend" and for all plans after the applicable April 1 date, the participant is entitled to a reasonable actuarial adjustment to reflect deferred commencement of benefit payments. With hybrid plans, interest credits alone may or may not be sufficient to meet this requirement. Supplemental interest credits needed to address this requirement are deemed not to exceed a "market rate of return" under the final regulations.

> **Comment.** Not surprisingly, the regulations do not provide any guidance about what actuarial assumptions are reasonable for this purpose, any more so than for the optional forms rule discussed above. The notion that unreasonable assumptions can lead to an impermissible forfeiture has been in regulations since the early ERISA period and specificity about what is reasonable for this purpose has never been provided.

Pension Equity Plans

The revised final regulations affirm that PEPs are not required to provide interest rate credits, but to the extent they do, the interest crediting rate must meet the market rate rules. This would apply, for example, for a plan that provides interest rate credits after termination of employment when PEP accumulation credits stop. The regulations also clarify that a PEP design that defines the plan benefit as a lump sum at normal retirement rather than a current value does not meet the definition of a lump sum-based benefit. Although it may be a formula that has an effect similar to a lump-sum based benefit formula, it would not be eligible for whipsaw relief.

The revised final regulations also offer an alternative to applying a participant's accumulated percentage to a final average compensation period — PEPs can calculate the benefit using a defined period when compensation was highest. For example, such a plan could use the highest 5 out of the last 10 years to determine average compensation.

Plan Termination Rates

Under PPA, a helpful rule for plan terminations allows a plan that uses interest crediting rates that are not fixed rates to use the average of those rates during the 5-year period ending on the plan termination date to determine benefits for periods after the termination date. This allows for increased certainty in determining the level of benefits that will need to be provided by annuity products purchased on behalf of participants who forego taking an immediate lump sum distribution.

For a plan using a rate that incorporates return on equity investments, IRS notes that a most recent 5-year average may not be suitable. It may be ridiculously high for long-term projection, or too low, or even negative. In the proposed regulations, IRS floated the idea of substituting the third segment rate for terminating plans. In response to comments that the third segment rate would make termination unduly costly, the final regulations call for the use of the second segment rate for the last calendar month that ends before the interest crediting periods that are included in the 5-year average.

The final regulations also allow 5-year averaging of rates used to convert accounts to annuity benefits, 5-year averaging of tabular factors, and generally, mortality based on the plan's updated mortality table (such as the 417 mortality table) at the participant's annuity starting date.

Proposed Anti-cutback Relief

Companion proposed regulations were issued describing the IRS' initial position on transitioning to the requirements in the final hybrid plan regulations in situations where the final regulations are more restrictive than what a plan currently has in place. The proposed regulations are generally effective as of the first plan year that begins on or after January 1, 2016. Thus any amendments adopted to change to a permitted interest crediting rate under the final regulations must be made before the effective date.

Ordinarily, an amendment changing the interest crediting rate on previously accrued benefits would not be permitted because of the anti-cutback rule. Invoking the right of the IRS commissioner to provide exceptions to the anti-cutback rule, the proposed rules would allow reductions in prospective interest crediting rates that comply with the requirements in the final regulations. Specific corrections would be prescribed for each noncompliant feature; compliant features of existing rates would be retained.

Comments Wanted

Comments on the proposed regulations must be delivered by December 18, 2014.

In some cases, for plans that base interest credits on the greatest of two or more rates, there may be multiple strategies for coming into compliance. For example, a plan that credits the greater of the third segment rate and a fixed rate of 6% would be permitted to either eliminate the segment rate or reduce the fixed rate to 4%. In other cases, such as a rate determined as the greater of two permissible variable bond-based rates, the proposal would apply a cap at the third segment rate. The IRS proposal would not allow the plan sponsor to simply change to any of the maximum compliant interest crediting rates. Instead the

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plan's current interest crediting rate structure would generally be retained overlaid with one of the regulatory maximums. For the investment-based rates, a change to a similar rate with similar risk and return would be required.

In Closing

Cash balance plan sponsors and their advisors are now generally equipped to assess their plans and determine any design changes that are required or desirable in light of the revised final regulations. If plan amendments are required, early planning will allow for timely amendments before the 2016 deadline. PEP plan sponsors have been provided with some additional guidance to consider; an action item on IRS' priority guidance plan suggests there is more to come.

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