

Market Rate of Return Rule Only Applies to Some PEP Interest – For Now

IRS has provided much needed clarity on whether the market rate of return rules described in current regulations apply to PEP plans. Plans that explicitly credit interest each year after principal credits stop are subject to the rules, while plans that instead convert to a benefit at normal retirement age using a deferred annuity factor (thereby implicitly crediting interest) are not. IRS is considering whether to issue additional regulations that would apply the rules to implicit interest PEPs and seeks comments on the how the rule would apply and the type of anticutback relief needed.

IRS is not currently changing the date amendments are needed for compliance with the many features in their final regulations. Sponsors of calendar year plans, including both implicit and explicit PEP plans, are reminded that amendments must be in place by January 1, 2017.

Background

Pension Equity Plans — “PEPs” — are hybrid plans that define a participant’s pension as a lump sum equal to an accumulated percentage of the participant’s final average compensation, highest average compensation, or highest average compensation during a limited period of years. Unlike a cash balance plan that accumulates pay and interest credits in defined contribution fashion, a PEP accumulates percentages and then applies the total percentage to the plan’s compensation definition at a determination date. When accruals under a PEP stop, the plan may provide explicit interest credits to the time of actual payment. Alternatively, some PEPs simply convert the PEP lump sum to an accrued benefit at normal retirement age using a deferred annuity factor that reflects interest (and sometimes mortality) for the deferral period. The lump sum offered at a later date increases to reflect the “implicit” interest in that deferred annuity factor.

Final regulations on hybrid plans, such as cash balance and PEP plans, define the maximum interest crediting rate a plan may provide without violating the Pension Protection Act of 2006 requirement limiting hybrid plan interest crediting rates to no more than a “market rate of return.” However, the regulations do not directly discuss whether



and how that maximum applies to PEP plans using implicit interest through a deferred annuity factor.

Our [October 2, 2014 For Your Information](#) provides highlights of the hybrid regulations; our [November 16, 2015 For Your Information](#) recaps the IRS rules for shifting to the final market rate of return requirements with amendments by the end of the 2016 plan year.

IRS Clarifies Status of PEP Market Rate Rule

In [Notice 2016-67](#), IRS has confirmed that interest credits in a PEP that provides explicit interest credits after principal credits stop are indeed subject to the market rate of return rule and must be corrected with an amendment by the end of the 2016 plan year if the rate that is used is faulty for some reason. For example, a plan using a 30-year Treasury rate as of the last day of the prior plan year would require an amendment to fix the time period for establishing the rate for the year. (Although the 30-year Treasury rate is acceptable, a single day snapshot is not.)

IRS goes on to say that a PEP that provides implicit interest credits by applying a deferred annuity factor is not subject to the market rate of return requirement as provided under the existing final regulations. As a result, these plans are both *not required* to be amended to comply with those rules and *not entitled* to rely on the anticutback relief provided to make such a change. If IRS issues future regulations imposing the market rate of return requirement on implicit interest PEPs, plan sponsors will be given adequate time to comply and will likely enjoy anticutback relief as well. IRS says that in no event would such a final rule apply any earlier than plan years beginning on or after January 1, 2018. If no such regulations are forthcoming, IRS will look to issue correction guidelines for plans that have already amended but did so unknowingly without anticutback relief.

Comment: Bear in mind that, aside from the market rate of return rules, there are several other key hybrid plan requirements that will apply to both kinds of PEPs and may require plan amendments prior to the end of the 2016 plan year.

Call for Comments

IRS is interested in whether constituents think that they should propose a rule to apply market rate of return requirements to the interest rates used by implicit interest PEPs. The agency views adjustments to reflect preretirement mortality imbedded in the deferred annuity factor as part of the implicit rate, so comments would need to consider that aspect as well.

IRS would also like suggestions on anticutback correction methods to offer if they do not amend the regulations to address plans that impermissibly reduced the implicit rate in the deferred annuity factor because they incorrectly thought that the current regulation required them to do so.

Comments may be submitted in writing on or before February 21, 2017.

In Closing

IRS' notice serves as a reminder that the deadline for hybrid plan amendments is coming soon. PEPs with explicit interest rate credits are subject to the current market rate of return regulation and may require an amendment to come into compliance on that feature — or on several others — by the end of the 2016 plan year. PEPs with

implicit interest rates may require amendments due to other hybrid plan requirements — but not the market rate rule ... for now.

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