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PENSION ANALYST

Importance information-Plan design

IRS issues final transition rules for hybrid plans

Who's affected

The final rules affect sponsors of hybrid plans, such as cash balance plans and pension equity plans. They also affect defined benefit plan sponsors that are considering converting a traditional defined benefit plan to a hybrid plan design.

Background and summary

Hybrid plans, such as cash balance and pension equity plans, combine features of a defined benefit plan and a defined contribution plan. In 2014, the IRS issued final hybrid plan regulations to provide guidance on topics such as the expanded list of permissible interest crediting rates and combinations of rates, late retirement and optional forms of benefit. At the same time, the IRS also issued proposed rules to provide transition relief from the anti-cutback rules for those plans that used an interest crediting rate not permitted by the final regulations.

Recently, the IRS issued final rules that permit a plan sponsor of a hybrid plan that does not comply with the market rate of return requirement to amend the plan in order to change to an interest crediting rate that is permitted under the final hybrid plan rules without violating the anti-cutback rules.

The final rules also provide guidance regarding:
- Specific alternatives to correct an interest crediting rate;
- Participant-directed provisions; and
- Rounding of interest crediting rates.

Action and next steps

Sponsors of hybrid plans should read the guidance discussed in this *Pension Analyst*. We encourage plan sponsors to discuss the contents of this publication with their legal counsel and their plan's enrolled actuary to determine how this recent guidance affects their plans. In some situations, plan amendments may be needed.

These final rules are effective November 16, 2015 and generally apply to plan amendments made on or after September 18, 2014, or an earlier date as elected by the plan sponsor. The regulations do not apply to amendments made on or after the first day of the first plan year that begins on or after January 1, 2017. As discussed in this *Pension Analyst,* there are special dates that apply to collectively bargained plans.

In this issue

To satisfy the benefit accrual and age discrimination requirements, a hybrid plan must use an interest crediting rate that does not exceed the market rate of return. An "interest crediting rate" is the rate applied under the terms of the plan to increase a participant's benefit to the extent the benefit increase is not the result of a participant's additional service or imputed service for the employer.

A plan that credits interest must specify how those credits are determined and how and when they are credited. A plan must also specify the frequency with which interest credits are made. Interest credits must be made at least annually. If interest is credited more frequently than annually (for example, daily, monthly or quarterly) then the interest rate credit for that period cannot exceed the pro-rata portion of the annual interest credit. The interest rate may be compounded more frequently than annually.

Interest crediting rates are defined as either:

- Investment-based. Investment-based rates are based on a rate or return provided by the actual investments, taking into consideration the return attributable to any change in the value of the underlying investments. A rate of return that is based on the rate of return for an index that measures the change in the value of investments is also an investment-based rate; or
- Non-investment based. Non-investment based rates are either fixed rates of interest or bond-based rates, such as yields to maturity of bonds.

The final rules published in 2014 provided a list of IRS permissible interest crediting rates and combinations of rates that do not exceed the market rate of return. These rules are effective for plan years that begin on or after January 1, 2016.

Plan amendments

Before the first day of the plan year that begins on or after January 1, 2017, a plan that uses an impermissible interest crediting rate must be amended to change to a permitted rate. Under the anti-cutback rules, a plan is permitted to change the interest crediting rate for those benefits that have not yet accrued. However, the amendment cannot reduce benefits that have already accrued.

In order to allow plan sponsors to amend their plans to comply with the interest crediting rate requirements, the final rules allow a plan with an impermissible interest crediting rate to be amended with respect to benefits that have already accrued. The final rules provide that the new interest crediting rate would apply to accrued benefits, but only for those interest crediting periods that begin on or after the later of the effective date of the amendment or the date the amendment is adopted. In order to receive relief from the anti-cutback rules, the amendment must be adopted prior to the effective dates discussed below.

The final rules provide correction principles for correcting noncompliant interest rates. The general approach is to permit amendments that bring the plan into compliance by changing specific features that cause the plan's interest crediting rate to be noncompliant, while not changing other features of the existing rate. If the noncompliant rate has more than one noncompliant feature, each noncompliant feature must be addressed separately. The final regulations permit a plan sponsor to choose one of two or more alternative amendments in order to bring a plan into compliance.

The final rules provide specific guidelines to correct noncompliant rates. For example:

- If a fixed interest crediting rate exceeds 6%, the rate must be reduced to 6%.
- If a plan's interest crediting rate is a composite rate that is the greater of two or more variable bond-based rates, the plan must be amended to provide for a rate that is the lesser of:
    - The composite rate or the third segment rate used for determining minimum required contributions under IRC section 430;
    - The third segment rate used for calculating lump sums under IRC section 417(e); or
    - The third segment rate for determining minimum funding under section 430 disregarding the funding stabilization provided by the Moving Ahead for Progress in the 21st Century Act (MAP-21), the Highway and Transportation Funding Act of 2014 (HATFA) or the Bipartisan Budget Act of 2015.

- If a plan has an impermissible investment-based rate, the plan must be amended to include one of the permitted rates based on the actual plan assets or regulated investment contract (RIC) that has similar risk and return characteristics as the plan's impermissible investment-based rate.

There are additional correction examples provided in the final rules.

Rounding of interest crediting rate

The final rules provide for a rounding rule. Under the rounding rule, a plan may determine interest credits for an interest crediting period by rounding the calculated interest rate or rate of return and still comply with the market rate of return requirements. An annual rate may be rounded to the nearest multiple of 25 basis points (or a smaller rounding interval). If a plan provides for crediting of interest more frequently than annually, then the rounding interval must not exceed a pro-rata portion of 25 basis points.

A plan is permitted to round to the nearest basis point regardless of the length of the interest crediting period.

Self-directed participant investments

The 2014 final rules discussed hybrid plans that permit participants to select the interest crediting rate from a menu of investment options. Due to concerns such as lack of participant investment knowledge, anti-cutback issues and fiduciary protection matters, the IRS is continuing to study this issue.

However, the final rules recognize that some of these "self-directed" plans may contain one or more investment options that provide for a noncompliant interest crediting rate. The rules include a special provision that the final rules may be applied separately to correct each investment option.

In addition, if a plan permitted a participant to select an interest crediting rate on September 18, 2014, the special rule provides that the entire menu of investment options may be treated as a noncompliant investment-based rate for which there is no permitted investment-based rate with similar risk and returns. As a result, plans may be amended to eliminate a participant's ability to choose an interest crediting rate.

Effective dates

These regulations apply to plan amendments made on or after September 18, 2014 (or an earlier date as elected by the taxpayer) and do not apply for amendments made on or after the first day of the plan year that begins on or after January 1, 2017.

Collectively bargained plans have a delayed effective date, which is:

- The first day of the first plan year beginning on or after January 1, 2019; or
- If the last collective bargaining agreement was ratified on or before November 13, 2015, and expires before January 1, 2019, the amendment must be adopted before the first day of the plan year that begins on or after the later of the date on which the last applicable collective bargaining agreement expires or January 1, 2017.

Next steps

Plan sponsors should read the contents of this publication to evaluate the impact of this recent guidance on their existing hybrid plans and determine if a plan amendment is required. They should review their plan's interest crediting rate to determine if it complies with IRS requirements. If they have any questions about the interest crediting rate rules, they should discuss this guidance with their legal counsel and their plan's enrolled actuary.

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Editor: Julie Koos (563) 585-6811

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