December 2014

PENSION ANALYST

Important information—Plan design

IRS issues final and proposed regulations for hybrid plans

Who's affected

These developments affect sponsors of and participants in 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 are common plan designs. A hybrid plan is a retirement plan that combines features of a defined contribution plan and a defined benefit plan.

The enactment of the Pension Protection Act of 2006 (PPA) into law on August 17, 2006, clarified the legal status of cash balance and other hybrid plan designs created after June 29, 2005, if they satisfied certain requirements such as vesting, conversions, age discrimination and market rate of return.

To assist plan sponsors in designing and administering their plans, the IRS issued final hybrid plan regulations in 2010 to reflect changes made by PPA. The IRS also issued proposed regulations that provided guidance on certain issues that were not addressed in the final regulations.

Recently, the IRS issued final hybrid plan regulations to provide guidance on outstanding issues not addressed in the 2010 final regulations. These rules provide important guidance on topics such as:

- Expanded list of permissible interest crediting rates;
- Late retirement; and
- Optional forms of benefits.

At the same time, the IRS issued additional proposed regulations. These proposed rules provide transition relief from the anti-cutback rules for those plans that use an interest crediting rate not permitted by the final regulations.

Action and next steps

Sponsors of cash balance plans should carefully read the information 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 most recent guidance impacts their plans. In some situations, plan amendments may be needed.

The final regulations generally apply to plan years beginning on or after January 1, 2016, except for those provisions that clarify prior rules that apply to plan years beginning on or after January 1, 2011. However, plan sponsors may choose to comply with the final regulations before January 1, 2016. Prior to that date, plan sponsors may also rely on the provisions of the 2010 proposed regulations, the 2007 proposed regulations and IRS Notice 2007-6.

In this issue

Hybrid plans, such as cash balance plans and pension equity plans (PEPs), are special types of defined benefit pension plans that combine features of a defined benefit plan and a defined contribution plan. Most hybrid plans express benefits as the value of a hypothetical account balance. Participants receive statements that reflect the accumulation of contribution or pay credits and interest credits to their hypothetical accounts.

Final regulations

Market rate of return

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 determine the interest crediting rate that will apply for each plan year using either:

- The applicable periodic interest rate that applies over the current period; or
- The rate used in accordance with a specified lookback month and stability period. The stability period and lookback period do not have to be the same as those used to determine lump sum payments under the plan.

Plans must specify the frequency at 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.

The final rules expand the list of permissible interest crediting rates that do not exceed the market rate of return. Plan sponsors cannot use interest rates that have not been authorized by the IRS. Plan sponsors may now use the following interest crediting rates to satisfy the market rate of return requirement:

- **Fixed interest rate.** A maximum annual interest rate of 6% is permitted. The proposed regulations had provided for a maximum 5% interest rate.
- **Rates based on government bonds with associated margins.** The final regulations provide that a plan may use an annual floor not to exceed 5% in conjunction with any of the rates permitted under IRS Notice 96-8, including government bond-based rates such as the 30-year Treasury rates. The rates permitted under IRS Notice 96-8 and the associated margins are as follows:

Interest rate bond index	Associated margin
The discount rate on 3-month Treasury Bills	175 basis points
The discount rate on 12-month or shorter Treasury bills	150 basis points
The yield on 1-year Treasury Constant Maturities	100 basis points

The yield on 3-year or shorter Treasury bonds	50 basis points
The yield on 7-year or shorter Treasury bonds	25 basis points
The yield on 30-year or shorter Treasury bonds	0 basis points

- **Segment rates for determining minimum contributions.** The first, second and third segment rates used for determining minimum required contributions under IRC section 430 are permitted. The final regulations allow these segment rates to be adjusted to reflect the funding stabilization rates reflected in the Moving Ahead for Progress in the 21st Century Act (MAP 21) or the Highway and Transportation Funding Act of 2014 (HATFA). There is an annual floor with a maximum of 4% in conjunction with these segment rates.
- **Segment rates for calculating lump sum payments**. The first, second and third segment rates used for calculating lump sums under Code section 417(e) satisfy the market rate of return requirement. There is a maximum annual floor of 4%.
- **Cost of living index**. The rate of increase of an eligible cost-of-living index with a margin up to 3% and a maximum annual floor of 5% is permitted.
- **Annuity contract rate.** The rate described in an annuity contract issued by a State-licensed insurance company. The contract rate cannot exceed the market rate of return.
- **Regulated investment company (RIC) rate of return**. The rate of return on a regulated investment company that is reasonably expected to be not significantly more volatile than a broad U.S. or similar international equities market is permitted. However, a RIC that has most of its assets invested in securities of issuers concentrated in an industry sector or a country other than the United States is not permitted.
- **Actual rate of return on plan assets**. A plan may credit interest equal to the actual rate of return on the aggregate of plan assets provided the assets are diversified to minimize volatility. The final rules also offer plan sponsors the ability to design a plan so that the participant's benefit is adjusted based on a **subset** of plan assets. For example, a plan sponsor may wish to credit interest based on the rate of return that differs for different groups of participants (such as using a more conservative subset of plan assets for long service employees). The actual rate of return on a subset of plan assets is permitted provided the:
  - Subset is diversified to minimize volatility;
  - Aggregate fair market value of qualifying employer securities and real property held in the subset does not exceed 10 percent of the fair market value of the aggregate value of the aggregate assets in the subset;
  - Fair market value of the assets within the subset must approximate the benefits related to the subset, determined using reasonable actuarial assumptions; and
  - All assets are still available to pay all benefits.

  However, the regulations do not provide guidance if a plan credits different interest rates for different groups. For example, the regulations do not address potential age discrimination issues if more conservative interest credits are granted to longer service participants or cutback concerns if the interest credit changes over the participant's career.

If a plan uses an interest credit based on the actual rate of return on plan assets or a RIC rate of return, the plan may use a 3% minimum rate that applies cumulatively (not annually) beginning on the date of contribution and ending on the participant's annuity starting date.

However, plans cannot credit the greater of two acceptable crediting rates. For example, a plan cannot credit the greater of the return on plan assets or a fixed interest rate of 6%.

The final regulations allow the IRS Commissioner to issue future guidance to increase existing rates or expand the list of approved rates. This guidance would be published in the Internal Revenue Bulletin.

Negative interest rates

Defined benefit plans are required to comply with benefit accrual rules to ensure that the plan provides sufficient accruals at ages prior to normal retirement age. Pay credits and interest credits reflect benefit accruals in hybrid plans. Most hybrid plans use the $133^1/_3$ percent accrual rule which provides that the annual rate at which a participant can accrue a normal retirement benefit for any year must not be more than $133^1/_3$% of the annual rate at which the participant can accrue a normal retirement benefit in any preceding year. The 2010 proposed regulations provided that a plan with a variable rate that could be negative could assume a minimum interest rate of zero percent to satisfy this benefit accrual rule. The final regulations include this same provision.

Self-directed participant investments

In 2010, the IRS requested comments regarding whether a hybrid plan should be able to offer participants the opportunity to select the interest crediting rate from a menu of investment options. The menu of hypothetical investment options might include various equity or fixed income investment alternatives, potentially including options similar to balanced or target date funds.

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. If the IRS concludes that participant choice is not permitted in a hybrid plan, it is anticipated that any plan that includes this feature on September 18, 2014 would receive anti-cutback relief that would permit the plan to be amended to provide for one or more appropriate alternative replacement interest crediting rates.

Late retirement

The final regulations confirm that a plan must provide either an actuarial increase after normal retirement date or satisfy the suspension of benefits rules for a participant who continues employment after his normal retirement age. The regulations provide that if a cash balance plan does not suspend benefits, it will need to provide for adjustments in excess of the benefits determined if the interest crediting rate is not sufficient to provide the required actuarial increase.

Optional form of benefits

The 2010 proposed rules permit a hybrid plan to calculate optional forms of benefit based on the actuarial equivalent of the participant's current balance of the hypothetical account using reasonable actuarial assumptions. The final regulations clarify that this rule also applies to subsidized optional forms of benefit, including an early retirement subsidy. If an optional form of benefit is greater than the actuarial equivalent of the current account balance, the plan will satisfy the vesting and benefit accrual requirements.

However, if an optional form of benefit is not at least equal to the actuarial equivalent of the current account balance, then relief does not apply.

Proposed regulations

The 2010 final regulations clarified that the right to future interest credits that are not conditioned on future service are a protected benefit. Therefore, an amendment to revise the interest crediting rate on accrued benefits is a prohibited cutback if under any circumstances, the revised rate results in a lower interest credit rate as of any date after the amendment.

The proposed rules provide guidance that would permit a cash balance plan that uses an impermissible interest crediting rate to amend the plan to a permitted interest crediting rate without violating the anti-cutback rules. 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. The proposed rules would 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. The amendment would need to be adopted prior to and effective no later than the first day of the first plan year that begins on or after January 1, 2016. In addition, plan sponsors must provide a notice of benefit accrual reductions ("204(h) notice") within a "reasonable time" before the effective date of the plan amendment. A "reasonable time" is generally defined as at least 45 days before the effective date of the amendment.

The proposed rules provide specific correction principles for correcting non-compliant interest rates. The general approach is to permit amendments that bring the plan into compliance by changing the specific features that cause the plan's interest crediting rate to be noncompliant, while not changing other features of the existing rate. For example, if a plan uses a permissible bond-based rate but provides for an impermissible lookback month to determine interest credits, the plan must be amended to correct the lookback month while retaining the bond-based rate.

Plan sponsors cannot rely on the proposed regulations.

Next steps

Plan sponsors should read the contents of this publication to evaluate the impact on their existing hybrid plans and determine if plan design or administrative changes are required. For example, they should review their plan's interest crediting rate to determine if it satisfies the IRS requirements.

Sponsors of traditional plans that have been considering conversion to a hybrid plan design should carefully review the guidance provided in these regulations. In general, sponsors may want to discuss this guidance with their legal counsel and their plan's enrolled actuary. The plan's enrolled actuary is in the best position to provide assistance regarding these final and proposed rules.

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Editor: Julie Koos (563) 585-6811