

# *HRS Insight*

## *Human Resource Services*

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### *IRS Delays compliance deadlines for cash balance and other hybrid plans*

In 2010, IRS issued final and proposed regulations addressing the requirement under PPA that interest credits under cash balance and other hybrid plans cannot exceed a market rate of interest. IRS Notice 2011-85 extends the deadline for complying with certain aspects of these requirements.

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This IRS has released a Notice extending certain effective dates and deadlines for cash balance and other hybrid pension plans to comply with new requirements enacted by the Pension protection Act of 2006 (PPA). In 2010, IRS issued final and proposed regulations addressing the requirement under PPA that interest credits under cash balance and other hybrid plans cannot exceed a market rate of interest. IRS Notice 2011-85 extends the deadline for complying with certain aspects of these requirements.

*For a discussion of some of the benefits of a cash balance design based on the 2010 IRS regulations, see HRS Insight 11/25*

**The Notice also extends the deadline for cash balance and**

**other hybrid plan sponsors to adopt amendments to comply with the market rate of return and other requirements enacted under the PPA from the last day of the 2011 plan year until at least the last day of the 2012 year.**

### **Background**

A cash balance, or other hybrid plan, is a defined benefit plan that contains some attributes of a defined contribution plan. Under PPA, interest credits for any plan year may not exceed a market rate of return. Therefore, cash balance plans may not provide annual interest credits in excess of a market rate of return. Pension equity (PEP) plans that credit interest for periods after termination of employment similarly may not credit



interest in excess of a market rate of return.

The 2010 final regulations provided important guidance on what is considered a market rate of return:

- The 30-year Treasury rate or the first, second or third-segment corporate bond rate used for minimum funding purposes or minimum lump sum purposes.
- The interest rates on shorter term Treasuries with specified margins and certain cost-of-living indices.
- The rate of return on an annuity contract for an employee issued by a licensed insurance company.
- An interest crediting rate equal to the actual rate of return on plan assets as long as the plan assets are diversified so as to minimize volatility. Under the final regulations, this rate of return is available only for indexed plans. The 2010 proposed regulations would extend it to cash balance and PEP plans.

The final regulations also provided that the IRS list of approved rates is exclusive. Any rate not included in the list will not be considered a market rate. The 2010 final regulations generally apply to plan years beginning on or after January 1, 2011.

The 2010 proposed regulations would further expand the list of approved market rates of interest to include:

- A rate of return on a mutual fund that is reasonably expected to be not significantly more volatile than the broad US or international equities market such as S&P 500, Russell 2000 index or broad based international index funds. Rates of return on industry sector funds, funds that are leveraged or country specific (other than U.S.) funds do not qualify.
- A fixed rate not more than five percent.

The 2010 proposed regulations allow for an annual floor of up to four percent to be used in connection with approved fixed income rates. A cumulative floor of up to three percent may be utilized in connection with an approved equity rate. The cumulative floor must be applied one time at the time benefit payments commence rather than on an annual basis. An interest credit of less than zero cannot result in the account balance at the time of payout being less than the aggregate amount of contributions credited to the account (the "preservation of capital" rule).

The 2010 proposed regulations would generally apply to plan years beginning on or after January 1, 2012. However, plans were permitted to currently rely on the market rate of interest provisions of both the final and the new proposed regulations.

## Notice 2011-85

Notice 2011-85 provides that the 2010 proposed regulations will not be effective earlier than the 2013 plan year. The Notice also provides that the

requirement that the regulations set forth the exclusive list of market rates of return is delayed until the proposed regulations become effective. Prior to that time, the list may be viewed as a non-exclusive list of safe harbor rates. The Notice does not delay the effective date of numerous other requirements in the 2010 final regulations.

The Notice addresses the expected deadline for plans that currently credit interest based on a method that is not an approved market rate to switch to an approved market rate without using a "wear-away" approach that grandfathers the pre-amendment account balance increased for future periods using the pre-amendment interest rate. The deadline for these plan sponsors to amend without a wear-away approach is expected to be the last day of the plan year ending before the proposed regulations become effective.

The Notice also extends the deadline for cash balance and other hybrid plan sponsors to adopt plan amendments to comply with the market rate of return and other requirements enacted under PPA from the last day of the 2011 plan year until the last day of the plan year ending before the proposed regulations become effective.

**Observation:** Since the IRS has not yet finalized the 2010 proposed regulations, the delay in the proposed 2012 effective date was necessary to provide plan sponsors sufficient time to evaluate those regulations after they are issued in final form and to determine if plan design changes are required or

beneficial. The specifics of those regulations will be of particular interest to plan sponsors that are considering providing interest credits that reflect equity returns based on mutual funds or on the actual return on plan assets. In the meantime, employers may continue to rely on the 2010 proposed regulations and, for example, adopt new cash balance plans with equity based interest credits or interest credits based on the actual return of plan assets as described in the proposed regulations. Further, sponsors of cash balance plans that credit interest based on one of the approved fixed income returns in the final regulations may switch to an equity based interest crediting method described in the proposed regulations using a "wear-away" approach. ERISA 204(h) notices will likely be required in this circumstance.

The delay in implementing the "exclusive list" of market returns position in the 2010 final regulations and the extended period for making changes without using a wear-away approach is relevant to those plans that currently credit interest based on a method that is not one of the approved methods in the 2010 final and proposed regulations.

**The delay in the deadline for adopting PPA amendments is significant for all cash and other hybrid plan sponsors.**

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