IRS issues final regulations on interest crediting for hybrid plans

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In brief

The IRS has released long-awaited final regulations addressing market rate of return issues for cash balance and other hybrid plans. The final regulations are based on regulations proposed in 2010 in connection with the first set of final regulations on hybrid plans after the Pension Protection Act of 2006 (PPA). Critical issues addressed by the new regulations include rules on the use of the actual rate of return on plan assets in cash balance plans, plan termination rules and compliance with backloading requirements. The regulations are generally effective for the first plan year that begins on or after January 1, 2016. The IRS also issued proposed regulations providing transition rules for plans that currently provide interest credits that are greater than a market rate of return under the final rules.

In detail

Background

A cash balance or other hybrid plan is a defined benefit plan that contains some attributes of a defined contribution plan. Under PPA, hybrid plans are treated as satisfying the age discrimination requirements under ERISA, the Internal Revenue Code (Code) and the Age Discrimination in Employment Act, provided that each participant's accrued benefit at any time would be equal to or greater than that of any similarly situated younger individual. The accrued benefit may be measured for this purpose as an annuity payable at normal retirement age (traditional plans), the balance of a hypothetical account (cash balance plans), or the current value of the accumulated percentage of the employee's final average compensation (pension equity plans). Hybrid plans must satisfy certain additional requirements, including the following:

- Interest credits for any plan year may not exceed a market rate of return. 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 pay credits to the account (the 'preservation of capital' rule).
- Participants must become 100% vested after three years of service.
- Certain restrictions apply upon the conversion of a traditional defined benefit plan to a hybrid plan that are designed to prevent 'wear-away' of a participant's prior accrued benefit.

2010 Regulations

IRS issued final regulations in 2010 addressing many issues, and provided important guidance on what is considered to be a market rate of return. The 2010 regulations provided a partial list of interest crediting rates that will satisfy the market rate of return requirements. The 2014 final regulations add to the list of market rates of return, and clarify additional issues raised in the 2010 proposed regulations.

Market rate of return

The 2010 final regulations contain a list of rates that satisfy the requirement that a plan not credit interest at an effective rate that is greater than a market rate of return, while not permitting other rates. Some commentators urged IRS and Treasury to provide a list of safe-harbor rates of return that comply but allow plan sponsors to adopt other rates that meet the requirements of the statute. However, the 2014 final regulations continue to specify an exclusive list of rates that qualify as market rates of return. The list of qualifying rates has been expanded slightly, and the regulations permit additional rates to be added by the Commissioner in official guidance. Under the 2010 regulations, each of the three segment rates used for the minimum funding requirements is a permissible interest crediting rate. The 2014 final regulations permit plans to use the unadjusted segment rates or the rates adjusted by the MAP-21 and HATFA legislation, which modify the segment rates to fall within a range of the average rates over a 25-year period. Changes in interest crediting rates with respect to credits that have already accrued must satisfy Code section 411(d)(6).

Interest credits based on plan assets

The 2010 proposed regulations allowed plans to credit interest based on the actual return on plan assets, but the interest rate was required to be based on aggregate plan assets. The 2014 final regulations allow plans to credit interest based on the return on a subset of plan assets. The subset will need to meet three basic requirements: (1) it must be adequately diversified, (2) it must be compliant with the 10% limit on qualifying employer securities and real property as if a standalone plan, and (3) it must reasonably approximate the liabilities for benefits that are adjusted by such rate of return.

Observation: *This is extremely helpful for plans with a portion of liabilities that are not connected to the actual return on plan assets, such as cash balance plans that include legacy benefits based on a traditional defined benefit formula or even traditional cash balance plans that credit interest based on bond yields. Plan sponsors will be able to invest the various pools of assets in a manner that better matches the liabilities those assets are intended to fund.*

The final regulations also note that different groups of participants can have interest credits tied to different subsets of the plan's assets, assuming that otherwise applicable requirements are met. For example, interest credits for longer service employees may be tied to a more conservatively invested subset of the plan's assets. In addition, a subset of plan assets can be associated with liabilities that are not adjusted, such as the liabilities for retirees.

Negative rates of return and backloading testing

The final regulations preserve the proposed rule for plans that credit variable rates of interest that can be negative, allowing the use of a 0% return in testing for backloading when the prior year's return was negative.

Observation: *While providing for a 0% return in lieu of a negative return in testing for backloading is helpful, the general issue can be somewhat limiting from a plan design perspective. Age weighted designs in which pay credits grow with age will need to be carefully examined for compliance with IRS backloading rules in plans that can potentially have a negative rate of return.*

Fixed rates and minimums

The proposed regulations provided that a fixed rate of return of up to 5% would be deemed not to exceed a market rate of return. The 2014 final regulations increase this rate to 6%. The final regulations also provide that plans that credit variable interest rates may utilize an annual floor of up to 5%, rather than the 4% included in the proposed regulations. The prior 3% cumulative minimum of the proposed regulations for plans that credit investment-based returns is preserved.

Interest credits after plan termination

PPA required terminating plans to provide interest credits following the plan termination date based on an average of the interest crediting rates provided under the plan in the 5 years leading up to the termination date. The proposed 2010 regulations required plans that credit investment-based returns to determine the 5-year average by substituting the unadjusted third segment rate for the actual rate credited under the plan. The 2014 final regulations replace the unadjusted third segment rate with the unadjusted second segment rate for this purpose, which will generally result in lower guaranteed interest credits following plan termination. The unadjusted second segment reflects the yield on intermediate term high quality corporate bonds and is currently around 4%.

Variable annuity plans

Under the 2010 regulations, the statutory exception for variable annuity plans from some of the requirements for hybrid plans was limited to cases where the variable annuity indexing was related to the rate of return on plan assets. The 2014 regulations expand this exception to plans that adjust benefits with respect to any permissible interest crediting rate under the rules.

Other items of note

- Self-direction. The preamble to the final regulations discusses participant choice among a menu of investment options. It lists the pros and cons of these plan designs, and notes that Treasury is still working through this issue. If the conclusion is that self-direction is not permissible, anti-cutback relief will be provided to allow pre-existing self-directed plans to change to an appropriate replacement rate that is compliant with the new rules.
- Projection issues. For certain purposes under the rules for defined benefit plans, calculation of the annuity equivalent of a cash balance account is needed. Although the regulations keep the rules on interest crediting for purposes of the backloading rules, the regulations do not address the general issue of projecting hybrid plan balances for other reasons such as nondiscrimination testing and section 415 limits.
- Actuarial increases for delayed commencement of benefits beyond normal retirement age. Cash balance plans, like all defined benefit plans, are required to provide an actuarial increase after normal retirement age unless benefits are suspended, and the regulations imply that an adjustment to the account may be needed to meet this requirement. The regulations provide that to the extent that this actuarial increase requires an increase in the account balance that is greater than the plan's interest crediting rate, it will not be treated as exceeding a market rate of return.

Observation: *To avoid having to provide interest credits in excess of the plan's crediting rate, plan sponsors should consider issuing suspension of benefits notices and allowing in-service distributions upon attainment of normal retirement age.*

Transition relief to amend noncompliant interest crediting

The 2014 proposed regulations would allow a hybrid plan that currently used an interest crediting rate that is not on the specified list of allowable interest crediting rates to change to a permissible rate without violating the anti-cutback rules. The new rate will apply to benefits that have already accrued, but only for interest credits for periods after the amendment is adopted, or if later, for periods after the amendment is effective.

If an investment-based interest crediting rate does not comply with the requirements set forth in the final regulations, the plan sponsor is permitted to amend the plan to replace the noncompliant investment-based interest crediting rate with a permissible investment-based interest crediting rate that has similar risk and return characteristics as the noncompliant rate. If this is not possible, then the plan should be amended to use a permissible investment-based interest crediting rate with less volatility that is otherwise similar to the noncompliant rate.

The general approach is to permit amendments that bring the plan into compliance by changing only the specific feature that causes the plan's rate to be non-compliant, and leaving alone the remaining features of the rate. For example, if a plan uses an otherwise permitted bond-based rate but has an impermissible lookback month to determine interest credits, the plan would have to be amended only to correct the lookback month and the bond-based rate would remain.

Observation: *Plan sponsors will need to review their plans to be sure they are compliant with the new rules. Many sponsors were waiting for the final regulations to clarify if changes were needed, but did not have clear guidance on how and when to make the changes. The final regulations specify that in most cases this can be done by 2016 without applying retroactive fixes or reducing existing participant balances*

Effective/Applicability Dates

The final regulations generally apply to plan years beginning on or after January 1, 2016. Plans are permitted to currently rely on the final regulations. The transition rules for plans with above market rate interest provide that plan amendments must be adopted by the last day of the first plan year preceding the plan year that begins on or after January 1, 2016 (the plan year for which the final hybrid plan regulations discussed above are effective).

The takeaway

In general, the final regulations are more responsive to employers' needs than those issued in 2010. Plan sponsors now have more flexibility to credit returns based on the return of a subset of the plan's assets. Allowable fixed rates of return and certain annual minimums have increased and plan termination rules are somewhat less onerous. Opportunities exist for current cash balance plan sponsors or organizations that have been waiting for more guidance.

Let's talk

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