Pension Plan Fix-It
Handbook

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New Guidance from IRS on Hybrid Plans Gives Sponsors Rate Options

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IRS recently issued additional guidance on hybrid retirement plans that may mean you need to amend your plan, if your plan's interest crediting rate is not in line with the new rates.

Hybrid plans include cash balance and pension equity plans, and are often used by defined benefit plan sponsors to reduce costs. The regulations announced Sept. 19 clarify rates options for plan sponsors and generally apply to plan years that begin on or after Jan. 1, 2016; they also update 2010 proposed and final regulations.

IRS issued both proposed and final regulations for hybrid plans on Oct. 19, 2010 (see April 2011 story). The 2014 final regulations provide guidance on issues not addressed in the 2010 final regulations, while also making changes to the final regulations. This is an overview of some key changes applicable to cash balance plans.

Background

Hybrid retirement plans include cash balance plans and pension equity plans. Cash balance plans mimic defined contribution plans in that a "hypothetical" account is created for participants. The account is credited with hypothetical contributions based on a percentage of the participant's compensation. The account is also credited with hypothetical interest.

Many plan sponsors have converted their traditional DB plan (usually one with an accrued benefit based on a combination of final average earnings and years of service) to a cash balance plan. But some plan sponsors that adopted them found themselves facing age discrimination and other lawsuits, including claims arising from communications describing the plan conversion (see July 2011 story).

In January 1996, IRS published Notice 96-8, which provided for the use of several safe-harbor interest rates to project hypothetical allocations to cash balance plans. The interest rates in the notice closely approximated the 30-year U.S. Treasury rate, on an annual basis, so that hypothetical account balances would be equivalent to single sums calculated using the federal tax Code assumptions to discount the participant's accrued benefit from normal retirement age to the age of distribution. By using these interest rates, the employer could elect to distribute the hypothetical account balance as the participant's single-sum distribution, without having to calculate present values under federal tax Code 417(e)(3).

So far, the most recently released IRS regulations have been favorably received by many actuaries and DB practitioners.

Market Rates of Return

The new and revised regulations should be reviewed in the context of each type of hybrid plan.

The 2010 final regulations provided that a hybrid plan satisfied federal age discrimination requirements only if the plan did not credit interest at a rate greater than a market rate of return. The final regulations from that time included a list of rates that would meet this requirement. However, IRS received comments from practitioners and pension investment managers requesting a number of variations (for example, a list of safe harbor interest-crediting rates in combination with other interest rates that would not be greater than a market rate of return; variable rates of return with a basis-point or interest-percentage reduction).

IRS concluded that it would not be administratively feasible for the agency to evaluate each combination of contribution rates to determine whether they exceeded a market rate of return. Instead, IRS expanded the list of acceptable rates (see box above) contained in the 2010 final regulations. It includes the provisions that:

- plans can use a fixed interest crediting rate of up to 6 percent of particpants' accrued hypothetical balance (up from 5 percent);

See *Andersen*, p. 2

Andersen (continued from p. 1)

- plans can use an annual floor of up to 5 percent (up from 4 percent), in conjunction with IRS's Notice 96-8 rates. The preamble to the 2014 regulations notes that the rates permitted under Notice 96-8, including the government bond-based rates such as the 30-year Treasury rate, are generally expected to be lower than the rate of interest on long-term investment-grade corporate bonds. As a result, the annual floor used in conjunction with the Notice 96-8 rates can be raised to some extent without adding so much additional value that the effective rate of return is greater than a market rate of return;
- plans can continue to use an annual rate of up to 4 percent together with the segment rates (averages of corporate bond rates over differing time periods — short-, mid- and long-term); and
- interest rate bond index (see table in the regulations).

The final regulations permit the use of a rate of return based on a subset of plan assets subject to certain conditions. The new preamble explains that some plan sponsors may want to credit interest differently for different groups of participants, such using a less-volatile rate for long-service employees.

The 2010 preamble asked for comments on permitting participants a hypothetical investment menu from which to choose interest crediting rates. IRS says it will continue to study the issue.

Transitional Amendments Before 2016

Plans that use an interest crediting rate that is not permitted under the final hybrid plan regulations must be amended. The amendment must be made on or before the first plan year that begins on or after Jan. 1, 2016.

2014 IRS Final Regulations Expand Acceptable Hybrid Retirement Plan Interest Rates

Interest rate bond index	Associated margin (in basis points)
Discount rate on 3-month Treasury Bills	175
Discount rate on 12-month or shorter Treasury Bills	150
Yield on 1-year Treasury Constant Maturities	100
Yield on 3-year or shorter Treasury Constant Maturities	50
Yield on 7-year or shorter Treasury Constant Maturities	25
Yield on 30-year or shorter Treasury Constant Maturities	0

Variable rate	Maximum permitted floor (in annual percentage)
Notice 96–8 rate (for example, yield on 30-year Treasury Constant Maturities)	5
1st, 2nd, or 3rd segment	4
Investment-based rate (for example, rate of return on aggregate plan assets)	3

A plan can change a benefit formula prospectively but is prohibited under federal tax Code Section 411(d)(6) from cutting back on accrued benefits.

The proposed rule would permit a plan that is not using a compliant interest rate to change it to a compliant one without violating the anti-cutback rules. However, specific changes are required, depending on the nature of the non-compliant feature. For example:

- If a plan credits interest in a cash balance plan in excess of 6 percent, it must be amended to reduce the annual interest crediting rate to 6 percent.
- If a plan credits interest based on a bond rate with a margin exceeding the permitted margin, it must be amended to reduce the margin to the permitted level.

Some commenters to IRS suggested that plans should be allowed to adopt any of the compliant interest crediting rates. IRS said it did not take this approach because "it would not require a sufficient connection between the specific feature that caused an interest crediting rate to be noncompliant, and would permit a plan sponsor to reduce the interest crediting rate more than is appropriate."

See *Andersen,* p. 3

Andersen **(continued from p. 2)**

What Does This Mean to Plan Sponsors?

With these IRS regulations and changes, plan sponsors have been handed more certainty about calculating a market rate of return if they offer hybrid plans. The ability to amend the plan's interest credit rates without violating the anti-cutback rules is a practical way to bring plans into compliance.

Plan sponsors should work closely with their advisers to determine how the regulations affect their plan. ❖

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