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Final and Proposed Regulations on Hybrid Pension Plans

Plan sponsors have been granted limited relief to bring cash balance interest crediting rates into compliance.

On September 18, the Internal Revenue Service (IRS) published final and proposed regulations for cash balance and other hybrid defined benefit plans. Hybrid defined benefit plans use a lump sum–based benefit formula. These regulations provide guidance on provisions that apply to hybrid plans under the Pension Protection Act of 2006 (PPA) and the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA). The final regulations modify and finalize regulations that were originally finalized and proposed in 2010, and the newly proposed regulations address transitional issues associated with changes required by the final regulations. Highlights of the final and proposed regulations follow.

Background

Hybrid pension plans, including cash balance and pension equity plans (PEPs), are plans that combine features of defined contribution and defined benefit plans. Benefit calculations under a cash balance plan are based on the value of a participant's hypothetical "account balance." Annual allocations under a cash balance plan, for example, are generally made based on a percentage of the participant's compensation, and "interest credits" are generally allocated to the hypothetical account balance. Because younger participants have more time to earn interest credits, an annual allocation made to a younger participant may provide a larger benefit at normal retirement age than the same allocation made to an older participant. To address such discrimination concerns, the PPA added provisions to the Internal Revenue Code (Code) to ensure that a hybrid formula that met specified requirements would be treated as satisfying other Code requirements applicable to tax-qualified plans, including age discrimination requirements. Among these PPA requirements is the restriction that interest credits not be greater than a market rate of return. An interest credit of less than zero under a variable interest crediting index, however, may not cause the account balance to be less than the aggregate amount of pay-based credits. The final regulations and newly proposed regulations provide guidance for compliance with these rules.

Final Regulations

Optional Forms of Benefit

The original proposed regulations provided, and the final regulations continue to provide, that the actuarial equivalent (determined using reasonable actuarial assumptions) of the then-current balance of the hypothetical account or other accumulated benefit can be used to determine annuity forms of distribution as of a distribution date prior to normal retirement. The final regulations also clarify that this rule applies to a subsidized optional form of benefit, including any early retirement subsidy or a subsidized survivor portion of a qualified joint and survivor annuity, but not to an optional form of benefit that is less than the actuarial equivalent of the cash balance account or PEP accumulation.

Interest Credits and Market Rate of Return

As noted, the age discrimination restrictions on hybrid plans do not permit an interest crediting rate in excess of a market rate of return. The IRS previously published a list of permissible safe harbor interest crediting rates, including yield curves (in three segments) for making funding assumptions and determining the lump sum present

value of annuities. Many commenters had lobbied to be allowed to use any measure of return actually available in the market. The final regulations do not accommodate this suggestion. Although the final regulations continue to specify which interest crediting rates are permissible, the list of authorized rates has been expanded.

A maximum annual fixed interest rate of 6% (up from 5% in the proposed regulations) is permitted by the final regulations. The final regulations also allow an annual floor of 5% (up from 4% in the proposed regulations) coupled with a permissible bond rate (or a 4% floor coupled with segment rates). Although the final regulations do not allow an annual floor with permissible investment-based rates (e.g., return on a mutual fund), they do permit a 3% floor applied cumulatively with any permissible investment return. Under certain conditions, a plan may also use the actual rate of return on all or a portion of plan assets or the rate of return on an insured annuity contract.

Plan Terminations

If the plan uses a variable rate for interest crediting purposes, then, on plan termination, the rate of interest used to determine accrued benefits must be equal to the average of the interest rates used under the plan during the five-year period ending on the termination date. The final regulations provide detail for determining this five-year average. The average rate would be used to credit interest after plan termination or to compute annuities payable after normal retirement age. Because the final regulations require these rules to be set forth in the terms of the plan, sponsors of hybrid plans will likely need to amend their plans.

Effective Date

The final regulations are generally effective for plan years beginning on or after January 1, 2016, but the portions of the final regulations that merely clarify provisions included in the original 2010 final regulations apply to plan years that begin on or after January 1, 2011.

Proposed Regulations

The original final regulations provided that the right to future interest credits that are not conditioned on future service is a protected benefit under Code section 411(d)(6). The final regulations clarify that the right to such future interest credits is part of the participant's accrued benefit for purposes of Code section 411(d)(6), so that the interest crediting rate cannot be changed as to previously accrued pay credits in a way that could, as of any future date, reduce the account balance attributable to those pay credits.

Many statutory hybrid plans currently credit interest under a "better of" formula, such as a floor rate of interest, that would not meet the final market rate of return requirements. These plans will need to amend their interest crediting rates prior to the effective date of the new rules. In addition, if a minimum interest rate in excess of an allowable rate was adopted to enable the plan to satisfy antibackloading benefit accrual rules (e.g., under a service-weighted formula), the formula for pay credits will also need to be revised.

The proposed regulations would permit a hybrid plan with a noncompliant interest crediting rate to be amended without violating the Code section 411(d)(6) prohibition on a plan amendment that reduces a participant's accrued benefit. Notably, the proposed regulations do not permit a blanket change from a noncompliant interest crediting rate to any of the compliant interest crediting rates. Rather, they limit a permissible amendment to bring the plan into compliance by changing only the specific feature that causes the plan's interest crediting rate to be noncompliant, while not changing other features of the existing rate.

Effective Date

To qualify for the anticutback relief, the proposed regulations require plan amendments 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. The IRS also proposes to allow plan sponsors to rely on this relief, as finalized, to plan amendments adopted during earlier periods.

Unresolved Issues

The U.S. Department of the Treasury and the IRS are continuing to study whether a hybrid pension plan may permit participants to choose from among a menu of hypothetical investment options to determine their individualized interest crediting rates. If the Treasury and the IRS conclude that such plan designs are not permitted, the final regulations indicate that hybrid plans that permit participant choice among a menu of investment options on September 18, 2014 will have anticutback relief to eliminate this impermissible feature.

Although the final regulations do not contain substantial guidance on PEPs, notably, the IRS currently has a separate project regarding these plans on its schedule of planned future guidance.

Finally, the antibackloading benefit accrual rules—specifically the 133 1/3% rule, on which most hybrid plans rely—require a plan to assume that the benefit accrual rate for the current year will be the benefit accrual rate for all future years. Hybrid plans using a variable interest crediting rate that results in negative interest credits for some years have difficulty satisfying the 133 1/3% rule. The original proposed regulations provided limited relief, allowing use of a zero rate of return to project benefit accrual rates for future years. Commenters found this insufficient and requested additional relief for these plans, permitting them to assume an average long-term rate of return for the benefit accrual rate for future years. The final regulations do not provide the requested relief, but instead retain the zero rate of return for projected benefit accrual rates.

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