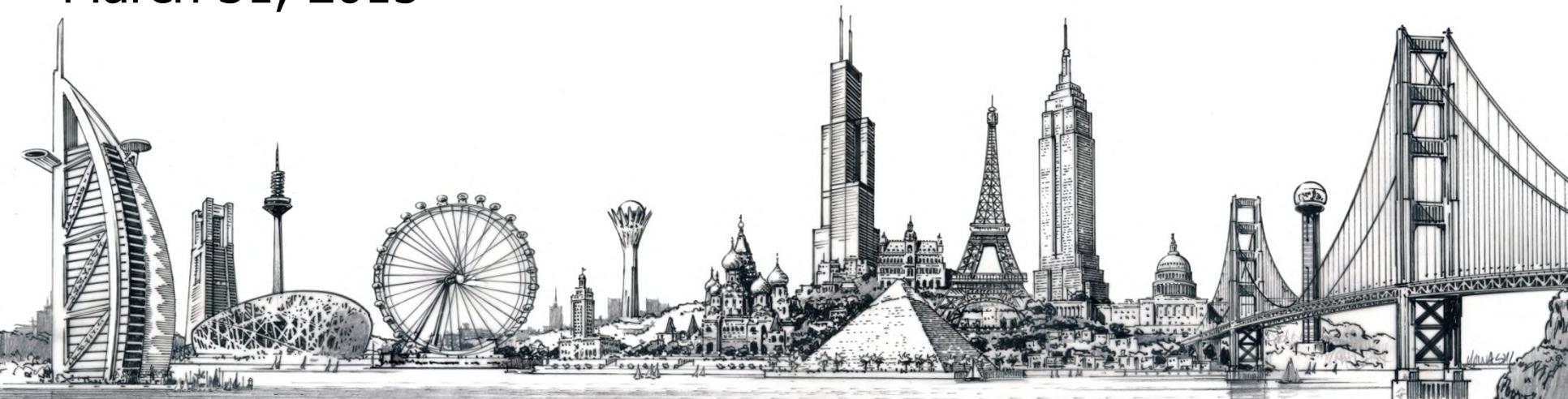


**Morgan Lewis**

**PLAN SPONSOR BASICS:  
CASH BALANCE PLANS**

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# Overview of Today's Training

- Introduction to Cash Balance Plans
- Brief Review of 2010 Final Hybrid Plan Regulations
- Brief Review of 2014 Final Hybrid Plan Regulations
- Brief Review of 2014 Proposed Hybrid Plan Regulations
- Potential Issues Plan Sponsors May Need to Resolve

# Introduction to Cash Balance Plans

- What is a cash balance plan?
  - Type of defined benefit plan
    - Subject to QJSA and QPSA requirements
    - Subject to funding requirements
    - Insured by PBGC
  - Benefit expressed as a hypothetical account balance
    - It is a hybrid plan with some defined contribution (DC) plan features
    - Accrued benefit typically determined by projecting an account balance to normal retirement age, but generally expressed as an account balance
  - Typical benefit formula has
    - Contribution credits
    - Interest credits

# Introduction to Cash Balance Plans

- What are the typical distribution options under a cash balance plan?
  - Typically treated like a DC plan
    - Distributions typically available at termination of employment
    - Lump sums equal to the account balance typically offered in addition to annuity options
    - Preretirement death benefit typically 100% of account, and payable to both surviving spouse and nonspouse beneficiaries if participant is unmarried (or spouse consents)

# Introduction to Cash Balance Plans

- Advantages of cash balance plans over traditional defined benefit (DB) plans
  - Portable
  - Easy to communicate
  - Like a DC plan, provides larger benefits to younger participants
  - More predictable costs; easier to match funding to liability

# Introduction to Cash Balance Plans

- A turbulent history
  - Became widely used in 1980s
  - Very little guidance
  - IRS Notice 96-8 provided guidance on “lump-sum whipsaw”
  - In 1999, IRS issued moratorium on determination letters for cash balance conversions
  - IRS issued proposed age discrimination regulations for cash balance plans in 2002 that were subsequently withdrawn

# Introduction to Cash Balance Plans

- Cash balance issues litigated
  - Conversions of traditional DB formula to cash balance
    - “Wear away”
  - Lump-sum “whipsaw”
  - Age discrimination by design
    - Cooper cash balance decision

# Introduction to Cash Balance Plans

- The Pension Protection Act of 2006 (PPA) resolved most outstanding cash balance issues favorably
  - PPA rules generally effective January 1, 2006
  - Legitimized cash balance design
  - Provided new safe harbor to satisfy age discrimination
  - Introduced protection of conversions of traditional DB formulas to cash balance formulas (A + B)
  - Market rate of return required to avoid age discrimination
  - Allowed plans to eliminate lump-sum whipsaw

# Introduction to Cash Balance Plans

- PPA added new requirements to cash balance plans
  - Introduced new three-year vesting requirement
  - Introduced requirement for terminating cash balance plans to use average interest over a five-year period if the plan uses a variable rate
  - IRS directed to issue regulations

# Brief Review of 2010 Final Hybrid Plan Regulations

- The Internal Revenue Service (IRS) issued a set of final hybrid plan regulations on October 18, 2010
  - Generally effective January 1, 2011
  - The regulations cover cash balance plans and other hybrid plan designs such as pension equity plans
  - We will cover the rules for cash balance plans
- Three-year vesting required for cash balance plans
  - Applies to the entire accrued benefit for plans with both traditional DB and cash balance components
- Relief from lump-sum whipsaw
  - Relief provided under Internal Revenue Code (IRC) section 411(a)(13)
  - Certain rules otherwise applicable to defined benefit plans not violated solely because benefits determined under a lump-sum-based benefit formula are based on current lump-sum amount under that formula

# Brief Review of 2010 Final Hybrid Plan Regulations

- Safe harbor rules for age discrimination under IRC section 411(b)(1)(H)
  - The accumulated benefit of any participant must not be less than the accumulated benefit of any similarly situated younger person
  - A participant is similarly situated if all factors in determining benefits are identical except for age
  - Must use market rate of return prescribed by IRS
- Market rate of return
  - Safe harbor rates include 30-year Treasury rate, 10-year Treasury rate, first segment rate, the second segment rate, and certain other bond and consumer price index (CPI) rates
  - Other permissive rates include the third segment rate, the rate of return on an annuity contract issued for the employee, and the actual rate of return on plan assets
  - Lookback period and stability period under IRC section 417(e) may be used to calculate the CPI and bond-based rates of return
- Right to future interest credits not conditioned on future service subject to IRC section 411(d)(6) protection

# Brief Review of 2014 Final Hybrid Plan Regulations

- The IRS issued another set of final hybrid plan regulations on September 19, 2014.
  - Generally effective for plan years beginning on or after January 1, 2016
- More rules on elimination of lump-sum “whipsaw”
  - Account balance must increase sufficiently after normal retirement age unless benefits are suspended
  - No whipsaw relief if prohibited reduction is made to accumulated benefit under a lump-sum-based benefit formula
    - Account balance must not be reduced in a manner that would be prohibited if the reduction were made to the accrued benefit
  - The regulations provide an exclusive list of the permitted reductions to the hypothetical account balance
    - Permitted reductions include benefit payments, QDROs, forfeitures of nonvested amounts, charges for qualified preretirement survivor protection, decreases as a result of negative interest crediting rate, and amendments to reduce the accrued benefit if permitted by IRC section 411(d)(6)

# Brief Review of 2014 Final Hybrid Plan Regulations

- Introduced whipsaw on optional forms (annuity whipsaw)
  - No whipsaw if optional forms subsidized (i.e., greater than current account value)
  - Whipsaw if optional forms less valuable (i.e., less than current account value)
  - If whipsaw applies, optional forms must be actuarially equivalent to accrued benefit
  - Reasonable actuarial assumptions not defined

# Brief Review of 2014 Final Hybrid Plan Regulations

- Relief from lump-sum and annuity “whipsaw” applies only to lump-sum-based benefit formula
  - Benefit expressed under terms of plan as current single-sum dollar amount equal to balance of hypothetical account (other rules for pension equity plans)
- New requirements for lump-sum-based benefit formulas
  - Single-sum payment must equal hypothetical account balance (except if single sum is greater to comply with IRC section 411(d)(6))
  - Portion of accrued benefit determined under that formula and then-current balance of hypothetical account are actuarially equivalent either
    - Upon attainment of normal retirement age
    - At the annuity starting date

# Brief Review of 2014 Final Hybrid Plan Regulations

- More safe harbor rules for age discrimination relief
  - Early retirement subsidies generally disregarded for the “similarly situated participant test”
    - Annual benefit for participant under normal retirement age must not be greater than the annual benefit for a similarly situated older participant
  - For plan years beginning on or after January 1, 2016, cash balance plan must use a lump-sum-based benefit formula
    - Lump-sum payment must equal accumulated benefit (account value), except to the extent required under IRC section 411(d)(6)
    - May need to eliminate lump-sum “whipsaw” for future accruals by end of 2015

# Brief Review of 2014 Final Hybrid Plan Regulations

- Cash balance plans with a variable interest crediting rate must generally comply with the IRC section 411(b) accrual rules using the current interest crediting rate
  - 133-1/3% accrual rule generally used by cash balance plans
  - May be issue if age-weighted formula
  - Negative interest crediting rates are assumed to be 0%

# Brief Review of 2014 Final Hybrid Plan Regulations

- New rules for opening balance conversions
- New market rates of return
  - Rate of return on a subset of plan assets permitted if certain requirements met (participant direction still not permitted)
    - Subset of plan assets diversified to avoid volatility
    - Aggregate value of qualifying employer securities and qualifying employer real property does not exceed 10% of the fair market value of the subset assets
    - Fair market value of assets within the subset of plan assets approximates the liabilities for benefits that are adjusted by reference to the rate of return on the assets within the subset, determined using reasonable actuarial assumptions
  - Rate of return on regulated investment company (mutual funds and ETFs) if certain standards met
    - Reasonably expected to not be significantly more volatile than US equities market or similarly broad international market
  - Fixed rate up to 6%

# Brief Review of 2014 Final Hybrid Plan Regulations

- Preservation of capital rule
  - Benefit at time of payment must be no less than total pay or contribution credits, without interest
  - Special rules apply if multiple annuity starting dates

# Brief Review of 2014 Final Hybrid Plan Regulations

- Minor changes to safe harbor rates and associated margins
  - Discount rate on three-month Treasury bills – 175 basis points
  - Discount rate on 12-month or shorter Treasury bills – 150 basis points
  - Yield on one-year Treasury constant maturities – 100 basis points
  - Yield on three-year or shorter Treasury constant maturities – 50 basis points
  - Yield on seven-year or shorter Treasury constant maturities – 25 basis points
  - Yield on 30-year or shorter Treasury constant maturities – 0 basis points
- Lesser of market rates permitted
- Rates not listed must be capped at one of the approved market rates

# Brief Review of 2014 Final Hybrid Plan Regulations

- Minimum annual interest rates permitted
  - 4% with first, second, or third segment rates
  - 5% with Treasury-based rates (Notice 96-8)
  - Cumulative 3% floor with investment-based rates
    - Shadow account
- Anti-cutback relief for changing lookback and stability periods for bond- and CPI-based interest crediting rates
  - Must credit interest for 12 months after later of date amendment adopted or effective using greater of old or new rate
  - Anti-abuse rule
- Market rate of interest requirements for amendments to change interest crediting rate for future accruals
  - Market rate of return rule not violated merely because the plan provides for benefit of any participant to be no less than the benefit under the old rate without taking into account principal credits after the applicable amendment date

# Brief Review of 2014 Final Hybrid Plan Regulations

- Different rates may be applied to predetermined portions of accumulated benefit (e.g., subaccount)
  - Each rate must be a market rate if applied to entire benefit
- Safe harbor rates and first and second segment rates may be changed to third segment rate if certain conditions satisfied
  - Change applies to interest credits after amendment
  - The effective date of amendment is at least 30 days after adoption
  - On effective date, new interest rate is not lower than old rate
  - Any fixed annual floor must be retained to the extent possible
  - No market rate issue for the change

# Brief Review of 2014 Final Hybrid Plan Regulations

- Interest credits may be credited to hypothetical accounts on an annual or more frequent basis
  - Interest credits not required on amounts distributed prior to end of interest crediting period
  - Increases or decreases to accumulated benefit may be taken into account during interest crediting period
- Rate of return on a RIC (mutual fund) that ceases to exist
  - IRC section 411(d)(6) not violated if a RIC ceases to exist, whether as a result of a name change, liquidation, or otherwise, if
    - Rate of return on successor RIC is used in case of name change or merger
    - Otherwise, the successor RIC must be selected by plan sponsor with similar risk and rate of return characteristics
- Participant direction among menu of hypothetical investment options
  - Continuing to be studied by IRS
  - If IRS concludes that participant direction is not permitted, IRC section 411(d)(6) anti-cutback relief is anticipated for plans that offered participant choice on September 18, 2014

# Brief Review of 2014 Final Hybrid Plan Regulations

- Requirements for terminating a cash balance plan have been clarified
- General requirements for terminating a cash balance plan
  - Variable interest rates generally required to be averaged over five-year period before termination
  - Second segment rate is substituted for investment-based rates
    - Adjusted for minimums and maximums
  - Interest rates for annuity conversions also required to be averaged
  - Cumulative floors not taken into account
  - 417(e) mortality updates after plan termination must be taken into account until annuity starting date

# Brief Review of 2014 Proposed Hybrid Plan Regulations

- The IRS issued proposed hybrid plan regulations on September 19, 2014, providing IRC section 411(d)(6) anti-cutback relief to comply with market rate of return requirements
- Reason for the relief
  - Plan amendments to comply with PPA hybrid plan rules and related final hybrid plan regulations required before January 1, 2016
  - Age discrimination relief under IRC section 411(b)(1)(H) applies to cash balance plans that do not provide interest credits in excess of a market rate of return
    - Amendment required if interest credits are above market rate or the plan uses an impermissible lookback month or stability period
  - IRC section 411(d)(6) generally provides that a plan does not satisfy section 411 if an amendment decreases a participant's accrued benefit

# Brief Review of 2014 Proposed Hybrid Plan Regulations

- A plan amendment reducing the interest crediting rate for benefits already accrued is ordinarily not permitted by IRC section 411(d)(6)
  - Future interest credits to the current account balance are considered already accrued for protected benefit purposes
  - Changes may be made to the future interest crediting rate for new accruals without issue
- A plan may be amended to reduce a section 411(d)(6) protected benefit if three conditions are met
  - The amendment constitutes timely compliance with a law change affecting plan qualification
  - The Commissioner exercises IRC section 7805(b) relief
  - The elimination or reduction of the section 411(d)(6) protected benefit is made only to the extent necessary to enable the plan to continue to satisfy the requirements for qualified plans

# Brief Review of 2014 Proposed Hybrid Plan Regulations

- General rules applicable to the relief
  - Corrective amendment must be adopted prior to and effective no later than the first plan year beginning on or after January 1, 2016
  - Relief applies to amendments adopted after the regulations are finalized
    - IRS proposes to apply relief to amendments adopted before the final regulations
  - Each noncompliant feature must be addressed separately
  - The specific feature that causes the plan interest rate to be noncompliant must be corrected, without changing other features
  - Not all noncompliant features are addressed in the regulations
    - Comments requested on how to correct investment-based rates with an impermissible minimum rate

# Brief Review of 2014 Proposed Hybrid Plan Regulations

- List of noncompliant features and how to correct them
  - Timing rules for determining and crediting interest not satisfied
    - Correct timing rules and retain underlying rate
  - Fixed rate over 6%
    - Reduce to an annual interest crediting rate of 6%
  - Bond-based rate with margin over the maximum permitted margin
    - Reduce to maximum permitted margin
  - Bond-based rate with fixed minimum that is too high
    - Reduce fixed minimum rate as needed
      - Reduce fixed minimum interest rate to an annual 5% rate if the bond-based rate is a Treasury bond rate
      - Reduce fixed minimum interest rate to an annual 4% rate if the bond-based rate is the first, second, or third segment rate, or
    - Credit interest using an annual interest rate of 6%

# Brief Review of 2014 Proposed Hybrid Plan Regulations

- List of noncompliance features and how to correct them (continued)
  - Composite rate equal to greatest of two or more variable bond-based rates
    - Credit interest using the lesser of (i) a third segment rate or (ii) the composite rate
  - Bond-based rate not on prescribed list
    - If a bond-based rate on the list prescribed in the regulations has similar duration and quality characteristics as the plan's variable rate, plan must credit interest based on that rate
    - If no rate on the prescribed list has similar duration and quality characteristics as the plan's variable rate, plan must be amended to credit interest using the lesser of the plan's variable rate and a third segment rate
  - Investment-based rate not on prescribed list
    - If an investment-based rate on the list prescribed in the regulations has similar risk and return characteristics as the plan's investment-based rate, plan must credit interest based on that rate
    - If no rate on the prescribed list has similar risk and return characteristics as the plan's investment-based rate, plan must be amended to credit interest based on a permitted investment-based rate of return that is otherwise similar to the plan's investment-based rate (generally less volatile but otherwise similar)

# Potential Issues Plan Sponsors May Need to Resolve

- Interest crediting rate not on approved list
- Impermissible lookback or stability period for bond-based rate
- Removal of lump-sum whipsaw if not already addressed
- Annuity whipsaw
  - May be issue if plan does not use one set of factors to convert between forms of payment
  - If factors are changed, need to consider requirement for qualified joint and survivor to be most valuable form
  - Old conversion factors may need updating
- Early retirement subsidy
  - Potential issue for plans with final average pay and cash balance components if the early retirement subsidy on the final average pay side does not satisfy nondiscrimination testing
  - If applied to lump-sum payment, may no longer be a lump-sum-based benefit formula

# Potential Issues Plan Sponsors May Need to Resolve

- Compliance with section 411(b) accrual rules
- Programming and recordkeeping changes
  - Waiting until end of year for more guidance may be problematic if no extension is granted by the IRS

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## QUESTIONS?

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April 29 | Section 4062(e)—Plant Shutdown Liability

May 20 | Retirement Plan Administrative Compliance Calendar

September 22 | Retirement Plan Correction Issues

October 14 | Fiduciary Issues for Defined Contribution Plans

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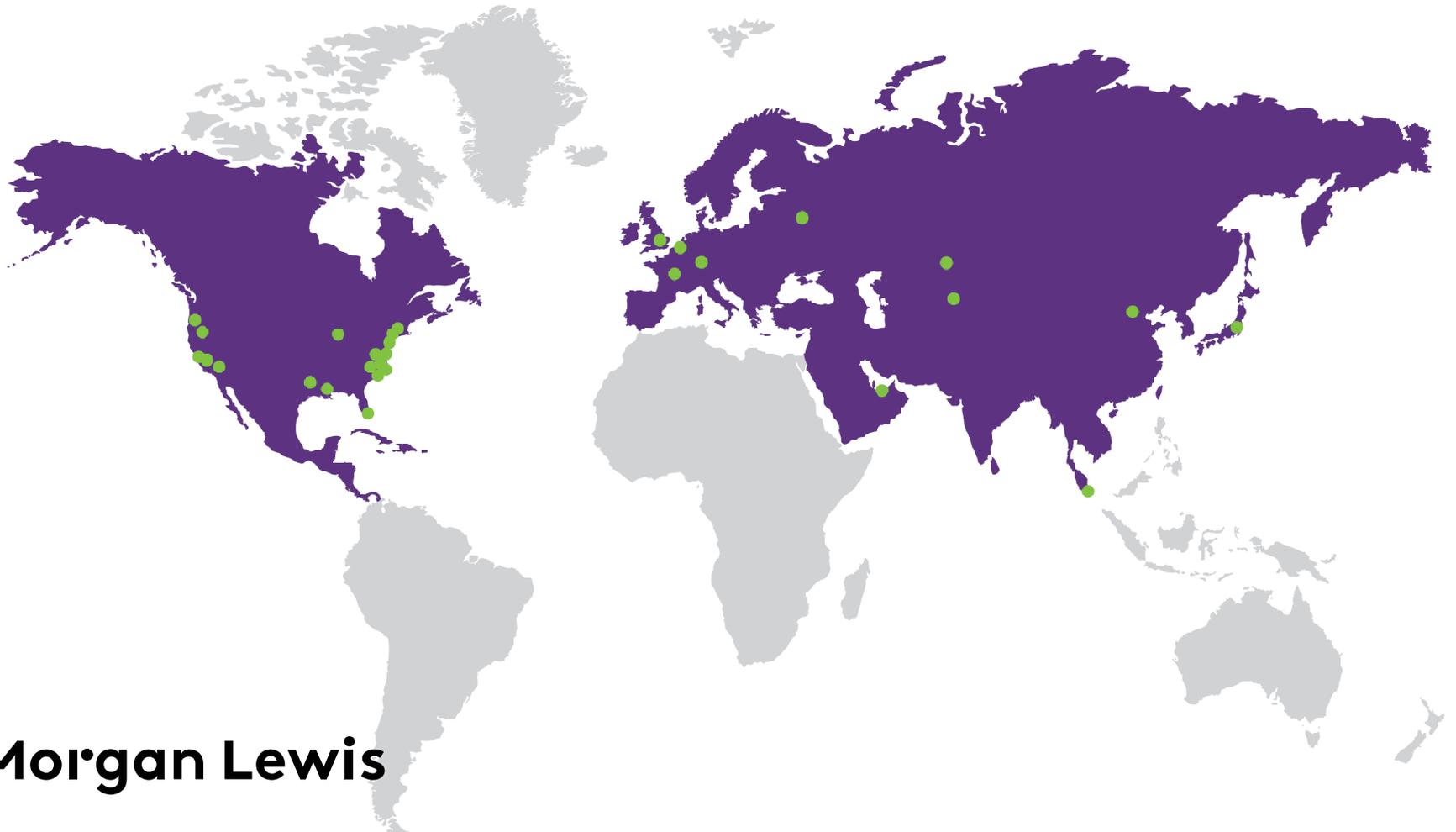
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