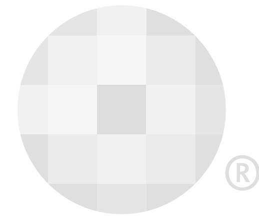
# Employee Benefits Corner

## Cash Balance Plans Get Final (and Proposed) Regulations

*By Elizabeth Thomas Dold and David N. Levine*



For many years, plan sponsors of cash balance plans have been awaiting final IRS regulations in order to determine if their benefit formula structure—particularly, the interest credits that are provided to plan participants until they take a distribution from a plan—is appropriate. In order to be appropriate, and therefore not raise any plan qualification concerns with the IRS, the rate must be a "market rate of return." Final IRS regulations[1] list out rates that make the final cut, and if a plan's rate does not make the list, then the proposed regulations provide needed transitional anti-cutback relief to permit a plan sponsor to change to a permissible rate that is on the list, but this relief is not available until these regulations are final (so a plan sponsor should consider pausing before amending their plan immediately). We summarize the key provisions of the final and proposed regulations below, along with action steps that should be taken to comply with these rules.

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## Market Rate of Return

A plan's "rate of return" must be a "market rate of return" because the IRS was concerned that as there is a cumulative floor on investment return of zero under a cash balance plan, this floor results in the need for limits on assets to avoid too much volatility, as the more volatile the assets the more valuable the floor, which is not otherwise available in the marketplace. We understand that there was also some concern regarding increased litigation exposure if there was increased flexibility of the permissible interest rates. Therefore, the response from the IRS was to remain focused on a rather limited list of interest rates. However, the IRS does retain the discretion to add additional rates to the list, if desired. Importantly, these rates are not safe harbors, but rather the exclusive list of approved rates. Accordingly, all cash balance plans must provide one of the following rates for interest credits, effective for plan years beginning on and after January 1, 2016:

- **Fixed Rate.** A plan can designate a flat, fixed rate of up to six percent. (This is an increase from the five-percent limit that was set forth in the proposed regulations.)

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| TABLE 1 | |
|---|---|
| **Interest Rate Bond Index** | **Associated Margin** |
| Discount rate on 3-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 |

If a plan had a rate of higher than six percent, the plan sponsor needs to amend down to six percent following the pending anti-cutback relief regulations.

- **Government Bond Rate.** Various government bond-based indices, with certain associated margins, are permitted, as set forth in Table 1.

  Minimum Floor (optional): up to five-percent annual floor

  For this rate, the plan sponsor must use a lookback and stability period that complies with the cashout rules under Code Sec. 417(e). Also, if the plan is amended to change the lookback or stability period, it must credit interest under the greater of the old and new approaches for a one-year transition period, similar to the existing rules for such changes under the Code Sec. 417(e) regulations.

  In particular, if a plan currently uses one of the government bond rates listed above, but with a higher associated margin, the margin must be lowered to the maximum amount noted above.

- **Corporate Bond Rate.** Any of the three corporate bond segments under the Code Sec. 417(e) rules—with or without adjustment for the pension funding "smoothing rules" enacted under the "MAP-21" and "HATFA" legislation. The same rules governing a change in the lookback and/or stability period that apply to governmental bond rates also apply to changes in corporate bond rates.

  Minimum Floor (optional): up to four-percent annual floor

- **Cost-of-Living Indices.** Certain widely used cost-of-living indices, such as various CPI measures, which can be increased by up to 300 basis points.

  Minimum Floor (optional): up to five-percent annual floor

- **Actual Return on Plan Assets.** Rate of return on plan assets, including positive and negative returns, assuming they are diversified to minimize volatility, in accordance with Department of Labor diversification standards. This approach may be used in concert with liability-driven investment strategy to minimum funding shortfalls.

  Minimum Floor (optional): No *annual* floor is permitted with this rate, but a *cumulative* floor of up to three percent is permitted.

  Significantly, the final regulations permit interest credits to be based on a specified subset of plan assets. To use this new option (1) the subset of assets must be diversified, (2) the subset of assets cannot consist of more than 10 percent employer securities, and (3) the fair market value of the assets in the subset must approximate the actuarial value of associated benefit liabilities. This feature was designed to permit different investment selections for different participants (*e.g.,* more equity-based investment mix for younger participants and more fixed income investments for older participants), but it may have some appeal for plans to more clearly align the growth of benefit obligations with the investment experience of related plan assets.

- **Certain Annuity Contract Rates.** For example, this includes a benefit formula determined with reference to an annuity contract for an employee issued by an insurance company licensed under the laws of a state, the rate of return on the market index specified under that contract.
- **RIC Return.**Rate of return (*i.e.,* net of fees) of a designated registered investment company (RIC) (*i.e.,* mutual

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fund) so long as the rate of return on the RIC is not expected to be significantly more volatile than the broad U.S. equities market (S&P 500 or Russell 2000 index) or a similarly broad international equities index market.

Minimum Floor (optional): No *annual* floor is permitted with this rate, but a *cumulative* floor of up to three percent is permitted.

And particularly, there is no cutback concerns if the RIC selected ceases to exist and the plan sponsor selects a successor RIC that has reasonably similar characteristics as the prior fund. Moreover, the IRS is considering whether to allow an annual floor if a haircut is imposed on the rate of return.

Notably, what did not make the initial list was participant-directed investments, but the IRS indicated that any plans with existing plan designs may qualify for the pending anti-cutback relief.

## Proposed Anti-Cutback Relief

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Any change to a plan's interest crediting rules that can result in a lower interest credit will be subject to the anti-cutback rules under Code Sec. 411(d)(6). The proposed relief is set forth below for plan sponsors that are required to change their interest rate because they fall outside one of the permitted methods noted above, provided that the plan sponsor follows the IRS method outlined below. Importantly, this anti-cutback relief is not available if a plan sponsor wants to change from one permitted rate to another rate as a matter of plan design—so it will be important to step carefully when changing rates to ensure that transition relief is utilized. Moreover, the relief granted herein is not effective until the final regulations are issued.

The proposed rules generally provide that each aspect of an existing interest credit provision that violates the final rules must be changed separately in the prescribed manner, but fail to provide general correction guidelines for designs that fall outside the scope of the specified deviations. Examples of prescribed modifications include the following:

- **Bond-Based Rate with Minimum Floor Violation**. Reduce the floor to the maximum permitted or change to a six-percent fixed rate.
- **Impermissible Government or Corporate Bond Rate.** Change to a permissible variable rate that has similar duration and quality characteristics as the existing variable rate; otherwise, use the third segment (more than 20 years) corporate bond rate under Code Sec. 417(e).
- **Impermissible Investment-Based Rate.** Change to a permitted investment-based rate that has similar risk and return characteristics; otherwise, use an investment-based rate that is otherwise similar to, but less volatile than, the impermissible rate.
- **"Greater of" Two Variable Rates.** Change to use the lesser of (1) the existing composite rate, or (2) the third segment (more than 20 years) corporate bond rate under Code Sec. 417(e).

*Notably, what did not make the initial list was participant-directed investments, but the IRS indicated that any plans with existing plan designs may qualify for the pending anti-cutback relief.*

## Other Miscellaneous Guidance

### Pension Equity Plans

The final regulations provide some preliminary guidance for pension equity plans (PEPs), including what types of PEPs are considered "lump sum-based benefit formula" plans subject to the hybrid plan rules (which excludes deferred PEP plans (*i.e.,* formula that produces a lump-sum benefit amount at normal retirement age)). Notably, the final regulations provide that a PEP benefit can decrease from one year to the next as a result of a decrease in the participant's final average compensation or as a result of an increase in the Social Security wage base where the benefit formula is integrated with Social Security.

### Preservation of Capital Rule Following a Five-Year Break in Service

The "preservation of capital" rule generally provides that a participant's total plan benefits may never be less than the amount of all principal credits added to his or her account over his career (*i.e.,* an overall zero-percent guaranteed rate of return). Understanding that this rule is difficult to administer when multiple distributions result from prior terminations and rehires, the final regulations permit plan sponsors to ignore prior benefits and distributions for a rehired participant who previously received a distribution of his or her entire vested benefit and then incurred a five-year break in service.


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## Valuation Rules for Pre-NRA Distributions and Optional Forms

The final rules also clarify the valuation rules for pre-normal retirement age distributions and optional forms of benefit by permitting the valuation to be based on the current value of the participant's account (in the case of a lump sum distribution) or the actuarial equivalent of the current account balance (in the case of an annuity) using reasonable actuarial assumptions. The rules also permit hybrid plans to provide early retirement subsidies (though they rarely do), subject to certain age discrimination safeguards.

## Plan Termination Rules

The regulations provide important details (including numerous examples) on the determination of interest crediting rates and actuarial equivalence factors upon plan termination. In general, these rules will need to be reflected in a final plan amendment.

## Timing of Amendment/Action Steps

The new market rate of return rules are generally effective for plan years beginning in 2016, which means that any corrective amendment must be adopted prior to, and be effective no later than, the first day of the plan year beginning in 2016. Moreover, we must leave time to comply with the ERISA section 204(h) notice requirements. Accordingly, a plan sponsor might consider the following steps:

1. **Review Plan Document.** Any hybrid plan should be reviewed for the following provisions to ensure compliance with the final regulations:
    a. *Interest Credits.* Review the current plan's interest credit rate with the list of permissible rates set forth in the final regulations.
        i. If the plan's existing interest rate made the list, then the plan is likely compliant. If a plan sponsor wants to change a plan's interest crediting rate, the amendment will need to comply with anti-cutback provisions (*e.g.,* retain the existing interest rate for benefits accrued to date, following a wear-away approach).
        ii. If the plan's existing interest rate did not make the list, the plan will need to be revised before the 2016 plan year to reflect one of the rates above. Unfortunately, it may be necessary to wait until the IRS finalizes the proposed anti-cutback relief regulations, and then track the permissible change very carefully. Any change to comply with these rules should be set forth in a timely ERISA section 204(h) notice.
    b. *Vesting and Accrual Rules.* Review the plan vesting and accrual rules for compliance with three-year vesting rules and benefit accrual rules under the final regulations as the deadline for adopting these changes runs through the end of the 2015 plan year.
2. **Update summary plan description and/or summary of material modifications and participant statements (as required under ERISA).** Any change in the interest credits should be timely reflected in a summary of material modifications and/or summary plan description. Also, the interest crediting rate should be shown or otherwise used in preparation of the participant statements.

### ENDNOTE

[1] 79 FR 56442 (Sept. 19, 2014).

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