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View From Groom: Long-Awaited Cash Balance Plan Guidance Presents Compliance Challenges and Opportunities

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Almost four years after proposing regulations for cash balance and other hybrid plans, the Internal Revenue Service recently issued final regulations addressing the market rate of return limits, as well as other aspects of the sweeping changes that were made in this area by the Pension Protection Act of 2006.[1] The IRS also published new proposed regulations that would provide transitional, anti-cutback relief for plans that must reduce the rate of interest to comply with the new limits.[2]

The new rules are generally effective for plan years beginning in 2016. The rules present both compliance obligations and design opportunities.

- Sponsors of defined benefit plans that contain cash balance or hybrid pension formulas need to consider if plan changes will be required before 2016—the most critical compliance issue for most plans will be to determine if the plan's existing interest crediting features meet the final rules, and, if they do not, how to transition to a new, compliant regime.

- Hybrid plan sponsors may also find other design changes desirable in light of the new rules, which address a number of new options.

- Traditional defined benefit plan sponsors may conclude that the more complete regulatory framework in this area now presents a good opportunity to take advantage of a hybrid pension benefit formula.

Key aspects of the new final rules and the proposed anti-cutback guidance are summarized below.

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Permitted Interest and Other Market Rates

Under the PPA, cash balance and other hybrid pension plan formulas may not credit interest to participant accounts at a rate that exceeds a ''market rate of return.''[3] This requirement is the primary focus of the new final and proposed regulations, which provide a number of changes and clarifications.

Many commenters had asked the IRS to provide a list of safe harbor rates—deemed to satisfy the ''market rate'' limits, analogous to the initial IRS list in Notice 96-8—and also generally permit other rates that do not exceed a market rate. IRS has concluded that such an approach is unworkable and instead has indicated that only those rates expressly described in the regulations, or in future guidance, will be permitted.[4] Consistent with the 2010 proposed rules, the current list of permitted rates is generally as follows:

- Specified fixed rate as high as 6%—if a plan determines interest credits solely based on a stated fixed rate, such rate cannot exceed 6%.[5] (The 2010 proposed rules would have limited a fixed rate to 5%.)

- Various government bond-based indices, with certain associated margins permitted.[6]

- Any of the three corporate bond segments under the Code section 417(e) rules—with or without adjust-

[1] 79 Fed. Reg. 56442 (Sept. 19, 2014).
[2] 79 Fed. Reg. 56305 (Sept. 19, 2014).
[3] Code § 411(b)(5)(B)(i)(I).
[4] 79 Fed. Reg. 56450.
[5] Treas. Reg. § 1.411(b)(5)-1(d)(4)(v).
[6] Treas. Reg. § 1.411(b)(5)-1(d)(4)(ii).

ment for the pension funding "smoothing rules" recently enacted under the "MAP-21" and "HATFA" legislation.[7]

■ Certain widely-used cost-of-living indices, such as various CPI measures, which can be increased by up to 300 basis points.[8]

■ Rate of return on plan assets, including positive and negative returns, assuming they are diversified to minimize volatility.[9]

■ Certain annuity contract rates.[10]

■ Rate of return of a designated registered investment company (or "RIC") (*i.e.*, mutual fund) so long as the rate of return on the RIC is not expected to be significantly more volatile than the broad United States equities market (S&P 500 or Russell 2000 index) or a similarly broad international equities index market.[11]

A variety of special rules apply to one or more of the above rate approaches, as noted below.

■ ***Higher Minimum Floor Rates Allowed.*** Where a plan provides for interest credits based on the greater of a variable rate and a fixed rate, the following maximum fixed rate floors apply:

—5% annual floor permitted if variable rate is based on a permitted U.S. government bond or cost-of-living index[12] (the 2010 proposed rules would have limited this rate to 4%);

—4% annual floor permitted if variable rate is based on a permitted Code Section 417(e) corporate bond segment rate;[13]

—3% cumulative floor permitted if variable rate is based on an investment-based rate (e.g., return on plan assets or return on designated RIC).[14]

■ ***Subset of Plan Assets Allowed.*** In addition to allowing interest credits based on the overall return on all plan assets, the new rules allow interest credits to be based on a specified subset of plan assets.[15] To use this new option, the subset of assets (1) also must be diversified, (2) cannot consist of more than 10% employer securities, and (3) the fair market value of the assets in the subset must approximate the actuarial value of associated benefit liabilities.[16] This feature was not provided in the 2010 proposal, and may be an appealing way for plans to more clearly align the growth of benefit obligations with the investment experience of related plan assets.

■ ***Special Rules for a Rate Based on RICs.*** A plan is not currently permitted to use an *annual* floor return where a RIC is the basis for the interest credits, though a *cumulative* floor of up to 3% is permitted.[17] Also, if a plan designated a specific mutual fund as the basis for interest credits and the fund ceases to exist, the plan sponsor can amend the plan, without anti-cutback concerns, to designate a successor RIC provided that the new fund has reasonably similar characteristics to the former fund.[18]

■ ***Changes in Look-Back Month or Stability Period.*** If a plan credits interest based on a permitted government or corporate bond index, it must use the rate for the current period, or a look-back and stability period that complies with the cashout rules under Code Section 417(e).[19] Further, if the plan is amended to change the look-back 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 Section 417(e) regulations.[20]

■ ***Participant-Direction Not Expressly Permitted.*** In the preamble, the IRS describes many of the comments it received in support of participant-directed cash balance designs.[21] The IRS notes various legal concerns raised by such a design, and indicates that it will continue to study these issues.[22] The IRS suggests that, if it does conclude that such designs are not permitted, plans which currently provide for participant direction among a menu may qualify for anti-cutback relief.[23]

Transition Rules for Plans With Non-Conforming Rates

Generally, 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.[24] For existing plans that have a rate that does not comply with the final rules, the new proposed regulations provide anti-cutback relief provided that the plan is changed only in the manner permitted by the IRS.[25] The corrective amendment must be adopted prior to, and be effective no later than, the first day of the plan year beginning in 2016.[26]

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.

■ ***Fixed Rate Too High.*** If a plan has a fixed interest rate in excess of 6%, it must be changed to a fixed rate of 6% (and not lower than 6%).[27]

■ ***Government Bond Rate With Margin in Excess of Permitted Margin.*** If the plan uses a permitted government bond index with an associated margin in excess of the permitted margin, the margin must be changed to the maximum permitted margin for that bond rate.[28]

■ ***Bond-Based Rate With Minimum Floor in Excess of Permitted Floor.*** If the plan uses a permitted bond index

[7] Treas. Reg. § 1.411(b)(5)-1(d)(3) and -1(d)(4)(iv).
[8] Treas. Reg. § 1.411(b)(5)-1(d)(4)(iii).
[9] Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii).
[10] Treas. Reg. § 1.411(b)(5)-1(d)(5)(iii).
[11] Treas. Reg. § 1.411(b)(5)-1(d)(5)(iv).
[12] Treas. Reg. § 1.411(b)(5)-1(d)(6)(ii)(B).
[13] Treas. Reg. § 1.411(b)(5)-1(d)(6)(ii)(A).
[14] Treas. Reg. § 1.411(b)(5)-1(d)(6)(iii).
[15] Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii)(B).
[16] *Id.*
[17] Treas. Reg. § 1.411(b)(5)-1(d)(6)(iii).
[18] Treas. Reg. § 1.411(b)(5)-1(e)(3)(v).
[19] Treas. Reg. § 1.411(b)(5)-1(d)(1)(iv)(B).
[20] Treas. Reg. § 1.411(b)(5)-1(e)(3)(iv).
[21] 79 Fed. Reg. 56455-56.
[22] *Id.*
[23] *Id.*
[24] Treas. Reg. § 1.411(b)(5)-1(e)(3)(i).
[25] 79 Fed. Reg. 56305.
[26] Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(vi)(B)(3); Treas. Reg. § 1.411(b)(5)-1(f)(2)(i)(B).
[27] Prop. Treas. Reg. § 1.411(b)(5)-1(f)(2)(i)(C)(2).
[28] Prop. Treas. Reg. § 1.411(b)(5)-1(f)(2)(i)(C)(3).

with a fixed floor rate that exceeds the permitted floor, the plan must be changed to either (1) reduce the floor to the maximum permitted floor, or (2) replace the existing index and floor with a 6% fixed rate.[29]

■ ***''Greater of'' Two of More Variable Bond-Based Rates.*** If a plan uses the greater of two or more permitted variable bond-based rates, then the plan must be amended to use the lesser of (1) the existing composite rate, or (2) the third segment corporate bond rate under Code Section 417(e).[30]

■ ***Impermissible Bond Rate.*** If a plan uses a bond-based rate that is not one of the permitted government-based or corporate-based bond rates, then the plan must be amended as follows: (1) if one of the permissible variable rates has similar duration and quality characteristics as the existing variable rate, the plan must use that rate, or (2) if (1) does not apply, the plan must use the third segment (more than 20 years) corporate bond rate under Code Section 417(e).[31]

■ ***Impermissible Investment-Based Rate.*** If a plan uses an investment-based rate that does not comply with the final rules, then the plan must be amended as follows: (1) if a permitted investment-based rate has similar risk and return characteristics as the existing investment-based rate, the plan must use that rate, or (2) if (1) does not apply, the plan must use an investment-based rate that is otherwise similar to, but less volatile than, the impermissible rate.[32] For a plan that uses an impermissible minimum rate with an investment-based return, the IRS asked for comments as to the appropriate options to change the rate to comply with the final rules.[33] For example, if a plan used a reduced investment-based rate with an annual floor, should the required amendment eliminate both the annual floor and the existing reduction to the rate?

■ ***Impermissible Timing Rules.*** If the plan's interest-crediting methods do not meet the required timing rules (e.g., the plan uses a bond-based rate with a look-back period that does not meet the look-back rules under the Code Section 417(e) regulations), then the plan must be amended to correct the aspect of its method that fails to meet those rules.[34]

While the proposed regulations set forth specific correction methods for specific violations of a plan's interest crediting provisions, it is not clear that all potential violations are addressed and no general principle is stated to guide the permitted transition in such cases. For example, some plans may use an investment-based rate with both an annual fixed floor and a fixed cap on returns. While the use of a floor, without a limit on the maximum return, could cause the investment-based rate to exceed a market rate, the application of the cap should, in many cases, ensure that the overall rate is not in excess of a market rate. However, these rules would require a change to the floor, without regard to the existence of the plan's cap.

The IRS will accept comments on these proposed rules until Dec. 18, 2014, and a public hearing is scheduled for Jan. 9, 2015.[35] Plans may not rely on the proposed rules, but may be able to retroactively apply the final rules to prior plan amendments.[36]

Special Rules for ''Pension Equity Plans''

The final rules provide some guidance on how ''pension equity plan'' (or ''PEP'') formulas—an area long devoid of any guidance—are to be treated under the hybrid plan rules.

■ ***PEP Definition.*** Generally, plans that express benefits as the current balance of an accumulated percentage of a participant's final average compensation or as a percentage of the participant's highest average compensation will be considered a ''lump sum-based benefit formula'' subject to all of the hybrid plan rules (these are commonly referred to as PEP plans).[37]

■ ***Permitted Reductions in PEP Balances.*** The final rules 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.[38] It is unclear whether the IRS has ever expressly acknowledged that a decrease in a participant's final average compensation can result in a permissible reduction in the participant's accrued pension benefit, consistent with vesting and anti-cutback requirements. This may be a helpful development for traditional final average pay plans as well.

■ ***Deferred PEP Plans.*** An offshoot of the PEP design is a pension plan formula that produces a lump-sum benefit amount at normal retirement age. For example, a plan may provide that a participant's benefit is equal to a lump sum amount at normal retirement age equal to an accumulated percentage of the participant's final average compensation. The final rules clarify that such a formula is *not* subject to the hybrid plan rules.[39]

The final rules do not address many other important aspects of PEP plans, such as whether PEPs are required or even permitted to credit interest to the PEP account following termination of employment. For PEPs that do credit interest after termination of employment, we understand that the IRS may be concerned that the implied interest promise could exceed the normal accrual rate while a participant is still working. The IRS has indicated that it is working to provide guidance on specific PEP issues as a separate project on the recently announced 2014-15 Guidance Priorities List.

Miscellaneous Additional Guidance

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.[40] For a plan with investment-based interest credits that can be nega-

[29] Prop. Treas. Reg. § 1.411(b)(5)-1(f)(2)(i)(C)(4).
[30] Prop. Treas. Reg. § 1.411(b)(5)-1(f)(2)(i)(C)(5).
[31] Prop. Treas. Reg. § 1.411(b)(5)-1(f)(2)(i)(C)(6).
[32] Prop. Treas. Reg. § 1.411(b)(5)-1(f)(2)(i)(C)(7).
[33] 79 Fed. Reg. 56308.
[34] Prop. Treas. Reg. § 1.411(b)(5)-1(f)(2)(i)(C)(1).
[35] 79 Fed. Reg. 56305.
[36] 79 Fed. Reg. 56307.
[37] Treas. Reg. § 1.411(a)(13)-1(d)(3)(i).
[38] Treas. Reg. § 1.411(a)(13)-1(b)(2)(ii)(F).
[39] 79 Fed. Reg. 56447.
[40] Code § 411(b)(5)(B)(i)(II).

tive in some years, these rules can be complicated to apply for a participant who has multiple distributions from the plan due to employment terminations and rehires.[41] The final regulations add a new rule of convenience that allows a plan 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.[42]

Valuation Rules For Pre-NRA Distributions and Optional Forms. The final rules clarify that pre-normal retirement age distributions can be based on the current value of the participant's account (in the case of a lump-sum distribution) or based on the actuarial equivalent of the current account balance (in the case of an annuity) using reasonable actuarial assumptions.[43] The rules also permit hybrid plans to provide early retirement subsidies (though they rarely do), subject to certain age discrimination safeguards.[44]

Plan Termination Rules. The final rules provide significant detail 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. Numerous examples are given.[45]

Next Steps for Plan Sponsors

This regulation package is very complex and requires careful study. Plan sponsors will want to consider their options carefully in consultation with their actuaries and legal counsel.

Fortunately, compliance is not required until 2016 so adequate time is available to make well-informed decisions.

[41] *See* Treas. Reg. § 1.411(b)(5)-1(d)(2)(ii).
[42] Treas. Reg. § 1.411(b)(5)-1(d)(2)(ii)(C).
[43] Treas. Reg. § 1.411(a)(13)-1(b)(3)(i).
[44] Treas. Reg. § 1.411(b)(5)-1(b)(1)(iii).
[45] *See* Treas. Reg. § 1.411(b)(5)-(e)(2).

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