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Pension & Benefits Daily ™

View From Groom: Final Cash Balance Regulations Provide More Time and Flexibility

BY MARK L. LOFGREN

At long last (after nine years), the Treasury and IRS can finally say they have issued a complete set of regulations addressing the broad changes made by the Pension Protection Act of 2006 (''PPA'') to the tax-qualification rules applicable to cash balance and other hybrid defined benefit pension plans. The newest installment of these rules, and the last piece needed to complete the set, were issued on November 13, 2015 (220 PBD, 11/16/15) (80 Fed. Reg. 70680).

These new regulations primarily make changes in the following two areas:

- They delay by one-year most of the rules that were reflected in final regulations issued in September of 2014. These rules will become effective as of the first day of the first plan year that begins in 2017. The rules had been scheduled to apply as early as January 1, 2016.

- They liberalize and finalize the transition rules that will govern how plans that currently employ an above-market interest-crediting rate must transition to a permissible rate, and make a few other helpful changes to the ''market-rate'' rules.

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Below is a summary of the changes made by this most recent set of regulations. The Appendix to this article summarizes all of the final rules regarding permitted interest-crediting rates and methods and the transition rules for correcting impermissible rates.

I. Delay in Effective Date

The new rules essentially extend by one-year the effective date of both the market-rate of interest rules and the age-discrimination safe harbor rules for cash balance and other hybrid plans. Additional time will be available for certain collectively bargained plans. This will give affected plan sponsors much needed time to consider and implement any changes needed to comply with all of these rules. In some cases, advance notice to participants may be required under ERISA section 204(h) to explain the impact of the required changes in the plan. This additional time will allow sponsors time to react and communicate appropriately to participants during 2016.

- *Market-rate rules*. The new regulations delay the effective date of the final ''market-rate'' rules until the first day of the first plan year beginning in 2017. The market-rate rules, which were finalized in September of 2014, contain an exclusive list of interest-crediting approaches and rates that must be followed for a plan to comply with the requirement to provide interest credits at a rate that does not exceed a market rate of return.

- *Other rules*. In addition to the market-rate rules, the final regulations issued in September of 2014 had provided 2016 effective dates for many other provisions. These other provisions relate to various rules applicable to the calculation of benefits payable under hybrid plans (e.g., the determination of amounts payable in the form of annuities, as well as lump sums) and to the safe harbor rules for demonstrating that these plans do not discriminate based on age. Treasury agreed that these rules should be postponed to allow plan sponsors to coordinate their plan provisions with both the market-rate rules and these other rules simultaneously. The new regulations postpone the effective date of these rules to the first day of the first plan year that begins in 2017.

■ *Collectively-bargained plans*. The new regulations provide special timing rules for plans maintained pursuant to a collective bargaining agreement (or agreements) entered into before November 16, 2015. For these plans, the January 1, 2017 effective date will be delayed further until the earlier of the first plan year beginning in 2019, and the plan year beginning after the date on which the last such collective bargaining agreement would expire.

II. More Flexible Transition and Other Market-Rate Rules

The new rules make a few helpful adjustments to the final market-rate rules and add helpful transition options for plans that currently employ a rate that is deemed to be above-market under the regulations.

■ *Rounding is permitted*. The final regulations now expressly allow a plan to provide for certain rounding conventions. For an annual return, a plan may provide that the rate is rounded to as much as the nearest 25 basis points – up or down. For returns that are applied more frequently than annually, the permissible rounding levels are pro-rated, but rounding to the nearest one basis point is always permitted.

■ *More flexibility to address an impermissible rate by using the third segment IRS corporate bond rate*. In several scenarios, the final rules include new alternatives to remedy an impermissible interest-crediting rate by switching the rate to the third segment IRS corporate bond rate (from Code section 417(e)(3)) (the ''Third Segment'' rate) – for bonds that mature over a period of more than 20 years – or by adding the Third Segment rate as a cap on the plan's existing rate method. This new alternative applies to the following impermissible rates:

♦ *Bond-based rate with minimum floor in excess of permitted floor* — can remedy by applying a cap set at the Third Segment rate with a fixed minimum of 4%;

♦ *Bond-based rate with impermissible margin or other impermissible features* — can remedy by applying a cap set at the Third Segment rate while retaining any minimum rate under the plan (which minimum may not exceed 4%);

♦ *Impermissible investment-based rate, where there is no permitted investment-based rate with similar risk and return characteristics* — can remedy by switching to the Third Segment rate with a fixed minimum of 4%;

♦ *Investment-based rates with annual floor or other floor that does not comply with the maximum permitted 3% cumulative floor* — can remedy by applying a cap set at the Third Segment rate while retaining any minimum rate under the plan (which minimum may not exceed 4%). This type of impermissible rate can also now be remedied by amending the plan to eliminate the floor, as well as any applicable ceiling or other reduction that applied to the investment-based rate.

■ *Use of Third Segment rate in lieu of permitted cap*. If a plan has a rate failure that can be remedied by applying the Third Segment rate as a cap, the plan can simply eliminate the prior rate and switch to the Third Segment rate instead (with the 4% minimum floor as applicable).

■ *Greater of two accounts*. Where a plan currently provides for a benefit based on the greater of two different account balances, e.g., where a prior account balance has been protected as a minimum due to a prior amendment to the plan's interest crediting rate, and the greater-of approach does not meet the market-rate rules, the plan must be amended to provide that each participant's ongoing benefit will be based on the greater of the accounts at the time of the amendment (and the lesser account is eliminated). If the surviving account has an interest-crediting rate that does not comply with the market-rate rules, it must be amended to comply in accordance with the other applicable transition rules.

■ *Plans that permit participant direction*. The final rules do not expressly permit a plan to allow participant direction of the investment/interest rate indices to be used to credit interest. The preamble to the regulation indicates that because of ''significant concerns'' relating to the use of these designs, the Treasury and IRS continue to study these issues. In the meantime, the final rules now allow the elimination of the participant-direction feature by replacing it with either (1) the Third Segment rate with a fixed minimum of 4%, or (2) a single investment-based rate. Alternatively, if one or more of the existing investment options do not meet the final rules, each of those options can be changed as necessary to comply with the applicable transition rules.

■ *Anti-cutback relief extended to plan's termination provisions*. The new rules expressly provide relief from anti-cutback restrictions for any plan changes needed to comply with the special regulatory requirements applicable in determining benefits upon plan termination.

III. Next Steps

With this set of final transition rules, the regulations on the hybrid plan rules enacted by the PPA are (finally) largely complete, though some issues remain unaddressed, such as certain rules for pension equity plans and a final decision about whether cash balance plans can allow participant-directed investment measures.

All sponsors of cash balance or other hybrid pension plans should now begin to take the following steps:

■ Review existing plan terms in light of the final set of comprehensive regulations to determine if any plan changes will be needed before the beginning of the 2017 plan year.

♦ *Age discrimination safe harbors* – determine if the plan needs to change in any way to fully comply with the regulatory safe harbors available to show compliance with age discrimination rules. For example, plan sponsors who did not previously eliminate ''whipsaw'' features in their plans are faced with the potential loss of safe harbor protection – although we understand that the IRS may issue additional guidance to address plans with a ''whipsaw'' feature.

♦ *Market-rate rules* – determine if the plan's interest-crediting rules will need to change to comply with the final rules.

♦ *Rules for valuations of distributions and other final rules* – determine if all other aspects of the plan meet the final rules, e.g., rules for valuing annuity distributions, or if changes will be needed.

■ Where changes are needed, consider what options may be available under the final rules and how a change may impact other plan compliance matters,

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such as compliance with anti-cutback rules (or exceptions to those rules) and meeting the IRS anti-backloading rules.

■ Consider participant communication issues for any required changes, including the possibility that advance notice under ERISA section 204(h) could be required where the change may reduce the rate of future benefit accruals.

APPENDIX – Interest Rate Options and Related Rules

Summary of Currently Permissible Interest Rates

The interest crediting rate rules in the comprehensive set of final regulations are generally summarized below.

The current list of permitted rates is generally as follows (in all cases the plan must also comply with the "principal preservation" rule, which requires that the account value at the time of distribution be no less than the principal credits made to the participant's account).

■ 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%.

■ Various government bond-based indices, with certain associated margins permitted.

■ Any of the three corporate bond segments under the Code section 417(e) rules – with or without adjustment for the pension funding "smoothing rules" recently enacted under the "MAP-21" and "HATFA" legislation.

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

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

■ Certain annuity contract rates.

■ 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 that the broad United States equities market (S&P 500 or Russell 2000 index) or a similarly broad international equities index market.

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

■ *Rounding is permitted*. The final regulations now expressly allow a plan to provide for certain rounding conventions. For an annual return, a plan may provide that the rate is rounded to the nearest 25 basis points. For returns that are applied more frequently than annually, the permissible rounding levels are pro-rated, but rounding to the nearest one basis point is always permitted.

■ *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 US government bond or cost-of-living index;

♦ 4% annual floor permitted if variable rate is based on a permitted Code section 417(e) corporate bond segment rate;

♦ 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).

■ *Subset of plan assets.* In addition to allowing interest credits based on the overall return on all plan assets, the rules allow interest credits to be based on a specified subset of plan assets. To use this 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. 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 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. 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.

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 a lookback and stability period that complies with the cashout rules under Code section 417(e). Further, 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 section 417(e) regulations.

Participant-direction not expressly permitted. The final rules do not expressly permit a plan to allow participant direction of the investment/interest rate indices to be used to credit interest. The preamble to the new regulation indicates that because of "significant concerns" relating to the use of these designs, the Treasury and IRS continue to study these issues.

Summary of 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. For existing plans that have a rate that does not comply with the final rules, the final rules provide anti-cutback relief provided that the plan is changed only in a manner permitted by the regulations. The corrective amendment must be adopted prior to, and be effective no later than, the first day of the plan year beginning in 2017 (possibly later for plans that are collectively bargained).

The 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.

The transition rules for non-conforming interest crediting rates in the comprehensive set of final regulations are generally summarized below.

■ *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%).

■ *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. As an alternative to ''fixing'' an impermissible margin or other feature of an existing bond-based rate, the plan can be amended to simply provide that the rate will never exceed the third segment IRS corporate bond rate, with application of any existing minimum rate under the plan (which minimum may not exceed 4%).

■ *Bond-based rate with minimum floor in excess of permitted floor.* If the plan uses a permitted bond index 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, (2) replace the existing index and floor with a 6% fixed rate, or (3) provide that the resulting rate may not exceed the third segment IRS corporate bond rate with a fixed minimum of 4%.

■ *''Greater of'' two variable rates.* If a plan uses the greater of two permitted variable rates, then the plan must be amended to use the lesser of (1) the existing composite rate, or (2) the third segment IRS corporate bond rate.

■ *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 IRS corporate bond rate.

■ *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 either (a) an investment-based rate that is otherwise similar to, but less volatile than, the impermissible rate, or (b) the third segment IRS corporate bond rate with a fixed minimum of 4%.

■ *Investment-based rates with annual floor.* If a plan uses an investment-based rate that is otherwise permissible, but also provides an annual or other floor that does not comply with the maximum permitted 3% cumulative floor, the plan can be amended to either (1) eliminate the floor, as well as any applicable ceiling or other reduction that applied to the investment-based rate, or (2) switch to the third segment IRS corporate bond rate (preserving any fixed minimum rate to the maximum extent permitted).

■ *Use of third-segment rate in lieu of permitted cap.* If a plan has a rate failure that can be remedied by applying the third segment IRS corporate bond rate, the plan can simply eliminate the prior rate and switch to the third segment IRS corporate bond rate instead (with the 4% minimum floor as applicable).

■ *Greater of two accounts.* Where a plan currently provides for a benefit based on the greater of two different account balances, e.g., where a prior account balance has been protected as a minimum due to a prior amendment to the plan's interest crediting rate, and the greater-of approach does not meet the market-rate rules, the plan must be amended to provide that the greater of the accounts for each participant at the time of the amendment is the benefit going forward. If that account has an interest-crediting rate that does not comply with the market-rate rules, it must be amended to comply in accordance with the other applicable transition rules.

■ *Plans that permit participant direction.* The final rules allow the elimination of the participant-direction feature by replacing it with either (1) the third segment IRS corporate bond rate with a fixed minimum of 4%, or (2) a single investment-based rate. Alternatively, if one or more of the existing investment options do not meet the final rules, each of those options can be changed as necessary to comply with the applicable transition rules.

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