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Milliman

CLIENT ACTION Bulletin
Employee Benefits

IRS Issues Final and Proposed Rules for Hybrid Pension Plans

SUMMARY

The IRS has published a final rule covering tax-qualified cash balance (hybrid) pension plans, providing guidance on the key issue of "market rate of return." Sponsors of hybrid plans have waited for four years for this guidance since the agency delayed the effective date of an October 2010 final rule following practitioners' concerns that the IRS had incorrectly interpreted the statutory definition. In general, the final rule applies to plan years that begin on or after Jan. 1, 2016.

The IRS also published a companion proposed rule to facilitate the transition for plan sponsors to adopt requirements, allowing for an election to apply the proposed rule to amendments adopted earlier than Jan. 1, 2016. The IRS seeks comments on the proposal by Dec. 18, 2014.

DISCUSSION

Market Rate-of-Return Requirements

The final rule provides greater flexibility than the 2010 regulations on the market rate of return, the statutory metric used to credit interest (i.e., the interest-crediting rate) on participants' hypothetical account balances. Commenters on the 2010 rule pointed out that the proscribed permissible rates of return and some of the permissible indices were neither broad enough nor representative of true market rates of return.The IRS now specifies that the hybrid plan's interest-crediting rate cannot be greater than the set of rates or indices established in the new final rule:

- a single, fixed, annual interest-crediting rate can be as high as 6% (increased from 5% under the 2010 final rule);
- the minimum annual interest-crediting rate associated with a U.S. federal government bond-based rate (as outlined in IRS *Notice 96-8*) or a cost-of-living-index-based variable rate may be as high as 5% (increased from 4%);
- the minimum annual interest-crediting rate associated with an investment-grade corporate bond-based rate (such as each of the three segmented yield-curve rates under the 2006 Pension Protection Act (PPA)) may be as high as 4%.

The 2014 final rule does not change the 2010 provision that permitted a cumulative 3% interest-crediting rate minimum for plans choosing investment-based or bond-based rates. Rather, the new final rule makes a clarification by changing the term *equity-based* rates to *investment-based* rates.

Prospective Amendments to Interest Crediting Rate

Under the proposed rule, the IRS will not require a plan sponsor to retroactively reduce a participant's hypothetical account balance prior to Jan. 1, 2016, if the plan used an interest-crediting rate that the final rule now deems to be in excess of a market rate of return. Instead, the final rule's new interest-crediting rate will be effective only on a prospective basis for the pay or principle credits for the first plan year starting in 2016. The IRS indicated that the regulatory compliance date of Jan. 1, 2016, provides plan sponsors sufficient time to amend their plans and notify affected plan participants. However, a plan sponsor can elect to change the interest-crediting rate prior to Jan. 1, 2016, without violating the plan's tax-qualified status.

Whipsaw/Early Retirement Subsidies

The PPA provided relief from so-called "whipsaw" calculations. Whipsaw is a technical anomaly in which the lump sum to be paid at the participant's annuity starting date is potentially higher than the hybrid account at the same date.

The new final rule permits the plan to voluntarily continue to pay a whipsaw lump sum. It clarifies that this permission also applies to a subsidized optional forms of benefit under a lump sum-based benefit formula, including an early retirement subsidy or a subsidized survivor portion of a qualified joint-and-survivor annuity.

Hybrid plans are not permitted to pay lump sums that are less than the cash balance account. The 2014 final rule clarifies that a plan must satisfy the general requirements applicable to defined benefit plan payments of the accrued benefit, including that non-lump-sum optional forms be subject to the minimum present value requirements (under tax code section 417(e)).

Back-loading Test

The new final rule maintains the 2010 methodology used in the application of the technical back-loading test, known in the tax code as the 133-1/3% accrual rate test. Under this test, a participant's account balances must be projected to each future year in his or her working career and each year's increase in accrued benefit cannot be more than 133-1/3% of that for any prior year. Conducting the test for any plan year requires that all relevant factors used to compute the projected benefits be treated as remaining constant as of the beginning of the testing plan year for all future plan years. For plans upon which the interest-crediting rate is based on an investment index and which incur an investment loss for the year, the investment loss is set to zero. The final rule leaves open the possibility for plans to fail the 133-1/3% rule and, in the most adverse scenario, for the IRS to disqualify the plan.

Variable Annuity Pension Plans (VAPPs)

Plan sponsors and multiemployer pension plan trustees considering the adoption of a variable annuity pension plan (VAPP) were provided a definitional clarification in the final rule. A VAPP under the final rule means any defined benefit plan formula that periodically adjusts the amount payable by reference to the difference between a rate of return and a specified assumed interest rate, and the rate of return is not limited to the rate of return on plan assets or specified market indices. If the VAPP formula adjusts the amounts payable by reference to any permitted interest-crediting rate, including the rate of return on plan assets or a subset of plan assets, the exception can be met only if the specified hurdle interest rate is 5%. The final rule's clarification may pave the way for employers to consider new retirement plan designs (see http://us.milliman.com/insight/employee-benefits-investment/ for more information about VAPPs).

Other Issues

The 2014 final regulations also included special provisions addressing: participants with multiple annuity starting dates; and in the instance of formal plan termination, determining an interest-crediting rate for periods that begin after the plan termination date and end on the date the pension is paid to the participants.

ACTION Hybrid plan sponsors should review the final and proposed rules to determine whether their plans comply. Plan amendments to bring the interest-crediting rate into compliance or to satisfy other requirements of the final rule may be necessary, with plan sponsors able to apply the transition rule if they so elect. Communications materials also should be reviewed and updated accordingly. Plan sponsors that wish to comment on the proposed rule should do so by Dec. 18, 2014.

For additional information about the final and proposed rules for hybrid plans or VAPPs, please contact your Milliman consultant.