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MULTIEMPLOYER ALERT
Update on Issues Affecting Taft-Hartley Plans

IRS issues final hybrid plan regulations with variable annuity pension plan implications

On September 19, 2014, the Internal Revenue Service (IRS) published final regulations providing guidance on hybrid pension plans that includes some items of interest to multiemployer pension plan trustees. Although mainly focused on cash balance and pension equity plans, the guidance includes provisions related to variable annuity pension plans (VAPPs), which have been drawing attention among trustees who believe there is enormous value in the defined benefit system. Some of the more onerous provisions needed to satisfy hybrid plan rules are now explicitly removed for VAPPs, and trustees adopting VAPPs have been given more flexibility in plan design. This Multiemployer Alert *goes into some of the details below.*

BACKGROUND

VAPPs, also referred to as variable defined benefit plans or adjustable pension plans, are defined benefit plans in which the benefits adjust up and down based on the actual investment return of the plan's assets. By adjusting the benefits in this way, VAPPs remain well funded in all market conditions and are able to provide lifelong benefits like traditional defined benefit plans while maintaining stable costs like defined contribution plans. As a result, VAPPs have experienced an increase in interest among trustees who are concerned about the sustainability of their current plans, but believe defined benefit plans continue to be the best vehicle for providing retirement security to multiemployer plan participants.

The funding stability of a VAPP comes at the cost of volatile benefits, even in retirement, which has been a major source of concern for trustees considering these designs. Many plans have explored options to minimize or eliminate this benefit volatility while maintaining funding stability, but prior to these new regulations it was unclear if these modifications would be approved by the IRS. The new guidance removes much of the uncertainty surrounding VAPP designs by specifically allowing such modifications, which gives trustees the opportunity to design VAPPs that have little chance of benefit decreases.

DEFINITION OF VAPP BROADENED

The new regulations broaden the definition of a VAPP by clarifying that benefit adjustments may be based on a rate of return that is not the aggregate return for all plan assets. This has two major implications for VAPP designs:

1. The final regulations confirm that it is acceptable for VAPP formulas to "cap" benefit increases. For example, the rate of return used to determine a VAPP's periodic benefit adjustments could be the lesser of the plan's actual rate of return and a fixed rate of return. This removes one of the primary areas of uncertainty for trustees that have been exploring these plan designs: namely, whether benefit increases can be capped in years when returns are especially high to build a reserve that can be used to mitigate or eliminate benefit decreases in years when the plan has poor investment returns. The final regulations clearly allow this.

2. The final regulations also clarify that it is acceptable to base benefit adjustments in a VAPP on the return of a subset of the plan's assets. For example, if a VAPP immunizes benefits through a dedicated bond portfolio to avoid benefit fluctuations for retirees, the benefit adjustments for non-retired participants could be based solely on the rate of return of the assets backing the non-retired benefits (i.e., without regard to the return on the dedicated bond portfolio).

EXCEPTION FROM HYBRID PLAN RULES CLARIFIED FOR VAPPS

Under previous IRS regulations, an exception was provided that allowed certain VAPP designs to avoid rules that generally affect hybrid plans. A VAPP that does not meet the two requirements outlined below will be subject to a few hybrid plan rules, including accelerated three-year vesting and certain protections required when converting a traditional defined benefit plan to a VAPP. For trustees considering a VAPP design, these additional rules have generally not played a significant role in their decision-making process, and that is unlikely to change under the new regulations. However, trustees adopting a VAPP that does not satisfy the requirements described below should be aware of the possibility that future regulations for hybrid plans, if any, could affect their plans. The final regulations clarify that a VAPP must meet two requirements to avoid being subject to the special hybrid plan rules:

1. The plan must have a specified assumed interest rate (or “hurdle” rate) of 5% or higher. Benefits in a VAPP adjust by the difference between the rate of return on plan assets (or other acceptable rate of return) and the plan’s hurdle rate. If the return on plan assets is above the hurdle rate, accrued benefits increase. If the return on plan assets is below the hurdle rate, accrued benefits decrease.

2. The plan’s periodic benefit adjustments must be based on a rate of return that meets the requirements of an interest crediting rate under the regulations. Acceptable rates of return include the rate of return on plan assets or a subset of plan assets, or the lesser of a fixed rate and the rate of return on plan assets or a subset of plan assets, in addition to other options described in the regulations.

SUMMARY

The final hybrid plan regulations issued by the IRS eliminate much of the uncertainty previously surrounding VAPP designs. Prior to these regulations, it was unclear if the IRS would approve VAPP designs that attempted to mitigate or eliminate the benefit reductions that would be inevitable if the plan’s benefit adjustments were based solely on the rate of return of aggregate plan assets. With this new guidance, trustees can explore VAPP designs without that uncertainty, allowing them to consider many different alternatives as they seek to design sustainable retirement plans that will meet the needs of participating employers, unions, and participants for generations to come.

FOR MORE INFORMATION

For more information on VAPPs or the impact of the new regulations on VAPPs and other hybrid plan designs, please contact your Milliman consultant. You may also learn more about VAPPs at www.milliman.com/insight/2014/Variable-annuity-pension-plans-An-emerging-retirement-plan-design.