IRS Issues Final and Proposed Hybrid Plan Regulations

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On September 19, 2014, the Internal Revenue Service ("IRS") released additional final regulations clarifying the rules regarding hybrid defined benefit pension plans. At the same time, the IRS also issued proposed regulations providing transition guidance for plan amendments to comply with the regulatory market rate of return requirements without violating the anti-cutback rules of Section 411(d)(6) of the Internal Revenue Code (the "Code"). Together, these regulations modify and supplement the 2010 IRS final and proposed regulations regarding hybrid plans.[1] These rules answer some long-standing questions and provide more certainty to sponsors of hybrid plans as well as employers considering this type of plan design.

Hybrid Retirement Plans Generally

Hybrid retirement plans are defined benefit pension plans that include certain features otherwise associated with defined contribution plans. One key feature is that hybrid plans provide for lump sum based benefits. A lump sum based benefit formula means any benefit formula used to determine all or any part of a participant's accumulated benefit under which the accrued benefit is expressed as the current balance of a hypothetical account maintained for the participant (generally, a "cash balance plan") or as the current value of the accumulated percentage of the participant's final average compensation (generally, a "pension equity plan" or "PEP"). A key element of the IRS guidance is that a hybrid plan will not be deemed to violate certain rules otherwise applicable to defined benefit pension plans (such as the vesting and accrual rules) solely because certain benefits are based on the current lump sum benefit amount determined under the hybrid plan formula.

2014 Final Regulations

Definitions of cash balance plan formula and PEP formula

The regulations do not alter the definition of a cash balance plan formula (where the accrued benefit is expressed as the current balance of a hypothetical account), but do expand the regulatory definition of a PEP formula. A PEP formula now includes a formula where the benefit is expressed as a lump sum amount equal to a percentage of the participant's highest average compensation over a certain period of time, such as the highest five years out of the last ten years a participant was employed with the employer. This expanded PEP definition applies for plan years beginning on or after January 1, 2016, or earlier, if so elected. The recent regulations also provide that, for plan years beginning on or after January 1, 2016, a lump sum benefit payment under both types of hybrid plans must equal the accumulated benefit under the applicable formula (unless the lump sum payment is increased in order to prevent a benefit cutback prohibited by Code Section 411(d)(6)).

Relief Under Code Section 411(a)(13)(A)

One source of the tax qualification relief for hybrid plans, Code Section 411(a)(13)(A), provides that, for vesting and accrual purposes, a hybrid plan may treat a participant's accrued benefit as the present value of the benefit accrued according to the plan's formula. The recent regulations clarify that this relief does not supersede the requirement that hybrid plans, like other defined benefit plans, must either properly suspend benefits for post-normal retirement age service or provide an actuarial increase in benefits. The regulations also clarify that the tax qualification relief applies to subsidized optional forms of benefits provided under a lump sum based benefit formula, such as early retirement subsidies or the subsidized portion of a qualified joint and survivor retirement annuity (QJSA). If an optional form of benefit is payable in an amount greater than the actuarial equivalent of the accrued benefit under the hybrid plan formula (using reasonable actuarial assumptions), then the plan will continue to satisfy the vesting and Code present value rules with respect to the amount of that optional form of benefit. However, the relief provided under Code Section 411(a)(13)(A) does not apply to an optional form of benefit that is worth less than the actuarial equivalent of the accrued benefit under the hybrid plan.

Variable Annuity Formulas

Under the regulations, certain requirements also apply to benefit formulas with "an effect similar to a lump sum based benefit formula." A plan with a variable annuity formula will not be considered to have an effect similar to a lump sum based benefit formula, and therefore will not be subject to the vesting rules and market rate of return requirements applicable to cash balance plans, if the variable annuity formula uses an assumed interest rate of 5% or higher. The regulations have broadened the definition of "variable annuity formula" for this purpose to include any formula that provides for benefit payments that are periodically adjusted by reference to the difference between a rate of return (not necessarily the plan's rate or a market rate) and a specified assumed interest rate. This exception from treatment as a lump sum based benefit formula has also been revised so that it is available in the case of a variable annuity formula that adjusts the amounts payable by reference to a permissible interest crediting rate (described below) including the rate of return on plan assets (or a subset of plan assets).

Backloading

Under one of Code Section 411(b)(1)(B)'s "anti-backloading" testing methods, a plan's benefit accrual rate may not exceed a prior year's rate by more than 133 1/3% (other formulas may be used under the anti-backloading rules, but the 133 1/3% rule is most commonly used by hybrid plans). The 2010 proposed regulations provided that if a hybrid plan credits interest based on a variable interest crediting rate (which could potentially be less than zero) and the most recent crediting interest rate was negative, a rate of 0% may be used in order to comply with the 133 1/3% rule for the current plan year and all future plan years. The recent regulations adopt this rule, with the modification that it can be applied to plan years beginning before January 1, 2012, if so elected (instead of applying only to plan years on or after January 1, 2012). The regulations also confirm that a hybrid benefit plan need not credit interest at all.

Age Discrimination

The 2010 IRS regulations provided an age discrimination safe harbor for hybrid plans under which a participant's accumulated benefit may not be less than the accumulated benefit of any "similarly situated" younger participant. If a hybrid plan did not satisfy this safe harbor, the plan was required to satisfy the general age discrimination rule in Code Section 411(b)(1)(H)(i). The recent regulations modify and expand the age discrimination safe harbor, providing that the age discrimination safe harbor is available not only for hybrid plans that determine participant benefits as either the sum of, the "greater of", or the choice of more than one type of formula, but also for a "lesser of" formula. The regulations also clarify that only lump sum based cash balance and PEP formulas are eligible for the safe harbor.

A plan may disregard the subsidized portion of an early retirement benefit in applying the age discrimination safe harbor. The regulations have been modified to provide that the subsidized portion of an early retirement benefit need not be contingent on a participant's severance in order to satisfy the safe harbor. This is intended to facilitate phased retirement. The regulations also provide that an early retirement benefit may be considered "subsidized" only if it provides a higher actuarial present value due to benefit commencement before normal retirement age. For plan years beginning on or after January 1, 2016, if the annual benefit payable before normal retirement age is greater for a participant than the annual benefit under the corresponding form of benefit for an older, similarly situated individual, who is at or before normal retirement age, then the difference between the benefit is not part of the early retirement subsidy and is not disregarded when applying the safe harbor.

Interest Crediting Generally

A hybrid plan may not credit interest to a participant's account balance at greater than a market rate of return. The 2010 regulations enumerated several types of interest rates that are deemed not to exceed a market rate. The new IRS regulations amend and expand the list of approved interest crediting rates. In addition, the IRS is now authorized to publish guidance directly in the Internal Revenue Bulletin to provide for additional permitted interest crediting rates.

Adjusted Segment Rates

The 2010 regulations provided that each of the three segment rates used by single-employer defined benefit plans to comply with minimum funding requirements is a permitted interest crediting rate. In 2012, the Moving Ahead for Progress in the 21st Century Act ("MAP-21") was enacted, permitting the segment rates to be adjusted within a specified range based on an average of segment rates for the prior 25 years. The Highway and Transportation Funding Act of 2014 ("HATFA") further modified the MAP-21 acceptable ranges. The recent regulations provide that a hybrid plan may credit interest using one of the unadjusted segment rates or one of the segment rates as adjusted by MAP-21 and HATFA. If future interest credits with respect to already accrued principal credits are determined using a segment rate, then any amendment to change the interest crediting rate must satisfy the anti-cutback protections of Code Section 411(d)(6).

Actual Rate of Return of a Subset of Plan Assets

The new regulations confirm that a cash balance plan may credit interest based on the actual rate of return on the aggregate assets of the plan, provided that plan assets are diversified to minimize volatility. The regulations also allow interest to be credited (and variable annuity plans to provide adjustments) based on a subset of plan assets if the following criteria are met: (1) the subset of plan assets is diversified to minimize volatility; (2) any qualifying employer securities and qualifying employer real property (under Section 407 of ERISA) do not exceed 10% of the assets in the subset; and (3) the value of the assets in the subset approximates the benefit liabilities that are adjusted by reference to the rate of return on the assets in the subset, determined using reasonable actuarial assumptions. The rate of return may be based on different subsets of assets for different groups of participants, if certain requirements are met, enabling plans to credit interest, for example, based on less volatile assets for long service employees who may be nearing retirement.

Hybrid plans are not permitted to credit interest using the rate of return of any given investment available under the plan sponsor's defined contribution plan, because such a rate in combination with the statutory cumulative zero floor may result in an effective rate that is greater than the market rate of return. However, a subset of the hybrid plan's assets could be comprised of investments that are options under the defined contribution plan, in which case the rate of return of the subset of assets could be used provided it meets all the applicable requirements.

Fixed Rates and Minimum Rates of Interest

The maximum permitted fixed interest crediting rate has been increased to 6% under the regulations (previously, a 5% maximum fixed rate had been proposed). Hybrid plans that credit variable interest rates may use an annual interest crediting rate floor of up to 5% in conjunction with any of the interest rates contained in IRS Notice 96-8. IRS Notice 96-8 sets forth interest rates that are projected to be lower than the interest rate on long-term investment-grade corporate bonds, so subjecting such rates to a floor results in less risk of higher-than-market interest rates. Hybrid plans may also use an annual floor of up to 4% in conjunction with the first, second or third segment rate.

In general, the IRS has recognized that permitting annual minimum interest crediting rates in conjunction with investment-based rates could cause cumulative returns to be greater than a market rate of interest. Accordingly, no annual interest rate floor is permitted to be used with investment-based rates permitted by the regulations, such as the rate of return on plan assets, a subset of plan assets, or a regulated investment company ("RIC"). However, the regulations permit a cumulative, as opposed to annual, interest rate floor to be applied, which provides less chance that the cumulative interest rate will exceed a market rate of interest. Under this provision, hybrid plans are permitted to provide that a participant's benefit as of the annuity starting date is equal to the greater of the benefit determined using the applicable interest crediting rate and the benefit determined using a fixed interest rate of 3% during the "guarantee period", which is the period to which the cumulative floor applies to the participant's benefit.

Additional Rules Regarding Interest Crediting Rates

Hybrid plans are not required to provide interest credits on an amount distributed during the interest crediting period, whether that period is an annual period or more frequent interval. Hybrid plans are also permitted to consider changes to a participant's accrued benefit during an interest crediting period when crediting interest for that period. The regulations clarify that, pursuant to the preservation of capital requirement, the accrued benefit must be compared to the sum of all principal credits and that the requirement is only applied as of an annuity starting date for a distribution of the participant's entire vested benefit as of that date. Special rules are provided where participants have multiple annuity starting dates.

Interest Rates Upon Plan Termination

Generally, a hybrid plan must provide that the interest crediting rate applied to benefits after plan termination must be equal to the average of the rates used by the plan during the five years prior to termination. However, this trailing five-year average may not be used for investment-based interest crediting rate hybrid plans, because it may reflect an unreasonably high or low rate. The regulations provide that such plans should substitute the second segment rate for the actual rate credited under the plan (rather than the third segment rate as originally proposed), because the second segment rate is frequently close to the rate used for plan funding purposes and will more closely mirror the plan's funding discount rate.

Anti-Cutback Rules

The regulations clarify that a participant's right to future interest credits under a hybrid plan as determined under the plan terms, to the extent not tied to future service with the employer, is a protected benefit under Code Section 411(d)(6).

The prior regulations provided that a hybrid plan that changes the interest crediting rate from an IRS Notice 96-8 rate, first segment rate or second segment rate to the third segment rate will not violate Code Section 411(d)(6) if (1) the change in interest rate applies only to interest accrued after the amendment effective date, (2) the amendment effective date is at least 30 days after the amendment is adopted, and (3) the new interest crediting rate on the amendment effective date is at least as high as the rate would have been on that date absent the change. The new IRS regulations add a fourth requirement: (4) if a plan used a fixed annual floor, it must be retained to the maximum extent permissible under the market rate of return rules.

The regulations further clarify which interest crediting rate a hybrid plan should apply in the case where the plan previously applied the rate of return of a RIC that has since ceased to exist, due to the RIC's name change, liquidation or other reason. In such case, the plan may substitute the rate of return of the successor RIC in order to avoid a Code Section 411(d)(6) violation. A "successor RIC", in the case where the RIC experienced a name change or RIC merger, means the resulting RIC. For other situations, the plan sponsor must select a successor RIC with reasonably similar characteristics to the prior RIC, including similar risk and rate of return.

Participant-Directed Hypothetical Accounts

The IRS had previously requested comments regarding whether hybrid plans should permit participants to "direct" the "investment" of their accounts to track certain pre-selected investment options, similar to self-directed investments in defined contribution plans. The preamble to the regulations notes that the IRS received many comments addressing the pros and cons of this option and will continue to consider the issue. However, the preamble also notes that "[i]t is possible that the Treasury Department and the IRS will conclude that such plan designs are not permitted." If self-direction is not permitted, plans that permitted hypothetical self-direction on September 19, 2014 (the day the 2014 Final Regulations were released) would receive relief from Code Section 411(d)(6) to be amended to provide for alternative interest crediting methods. Accordingly, even though this issue is not settled, hybrid plans should not introduce a self-directed interest crediting method that was not in place on September 19, 2014.

2014 Proposed Regulations

The latest IRS proposed regulations include rules that would permit a hybrid plan to amend its interest crediting rate to be compliant with the market rate of return requirement, without violating Code Section 411(d)(6) with respect to benefits already accrued, but only with respect to interest credits that are credited for interest crediting periods that begin on or after the later of the amendment effective date and the amendment adoption date. The general approach in the proposed regulations is to permit amendments that change the specific feature that causes the interest crediting rate to be noncompliant, and will not change other features of the existing rate. To qualify for this relief, such amendments must be adopted prior to, and be effective by the first day of the plan year beginning on or after January 1, 2016. Comments on these proposed rules must be received by December 18, 2014.

Next Steps

Employers maintaining hybrid defined benefit pension plans should review these regulations carefully and consult with their actuaries and other employee benefits professionals to consider any necessary changes or design opportunities. Although there are still some areas of uncertainty, the regulatory landscape has sufficiently cleared that many typical plan designs will survive agency scrutiny. Accordingly, employers that previously considered adopting a hybrid plan with a variable annuity formula but delayed implementation until more definitive guidance was available should once again consider moving forward with a variable annuity plan design. In addition, new plan designs will likely be promoted in light of the regulatory guidance and employers need to be prepared to test these designs against the new standards.

[1] For more information on the 2010 Regulations Please visit Proskauer's November 19, 2010 Client Alert "IRS Issues Cash Balance Plan Guidance", available at http://www.proskauer.com/publications/client-alert/irs-issues-cash-balance-plan-guidance.

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