MassMutual's ERISA Advisory Services℠

Internal Revenue Service Final and Proposed Regulations on Cash Balance and Other Hybrid Defined Benefit Retirement Plans

Background

The Pension Protection Act of 2006 (PPA) established a statutory legal framework for cash balance and other hybrid defined benefit plans (such as Pension Equity Plans, or "PEPs"). On December 21, 2006, the Internal Revenue Service (IRS) issued Notice 2007-6, which provided transitional guidance regarding PPA requirements for hybrid plans. On December 28, 2007, the IRS issued proposed regulations that incorporated the transitional guidance in Notice 2007-6, along with other proposed rules. On October 19, 2010, the IRS published final regulations (the "2010 final regulations") and additional proposed regulations (the "2010 proposed regulations") for hybrid plans.

The final regulations mirror most of the prior proposed regulations and transitional guidance, but provide some clarifications and additional changes. The 2010 proposed regulations provide additional guidance, particularly with respect to interest crediting rates which meet the "market rate of return" requirement applicable to hybrid plans.

The IRS has extended the deadline for certain amendments to comply with regulations affecting hybrid defined benefit plans to plan years beginning in 2014.

Key Provisions of the Final and Proposed Regulations

Definitions

PPA and the 2010 final and proposed regulations added significant definitions that are important to understanding the provisions of legislation and the 2010 final and proposed regulations.

Accumulated Benefit – A participant's benefit accrued to date under the plan (added by the 2010 final regulations, so that it is distinct from the "accrued benefit" under Internal Revenue Code (IRC) section 411(a)(7), which is an annuity beginning at normal retirement age that is actuarially equivalent to the participant's accumulated benefit). A participant's accumulated benefit may be expressed as the current balance of a hypothetical account, or current value of an accumulated percentage of a participant's final average compensation, even if the plan defines the participant's accrued benefit as an annuity beginning at normal retirement age that is actuarially equivalent to that balance or value.

Interest Credit – For purposes of the "market rate of return" requirement, generally any increase or decrease to a participant's benefit under a statutory hybrid plan that is calculated by applying an interest rate or a rate of return, to the extent not conditioned on current service or imputed service, to a participant's accumulated benefit as of the beginning of the period (defined in more detail under the Market Rate of Return Limitation section). The term "interest credit" generally also includes any other increase for a period under the terms of the plan, to the extent not conditioned on current service or imputed service.

Principal Credit – For purposes of the "market rate of return" requirement, generally any increase to a participant's accumulated benefit under a statutory hybrid benefit formula that is not the result of an interest credit (defined in more detail under the Market Rate of Return Limitation section).

Statutory Hybrid Plan – A defined benefit plan with a "statutory hybrid benefit formula".

Statutory Hybrid Benefit Formula – A benefit formula that is either a lump sum based formula, or a formula that has an effect similar to a lump sum-based benefit formula.

Similarly Situated Individual – For purposes of the safe harbor for age discrimination, an individual who is identical to another individual in every respect that is relevant in determining his or her benefit under the plan (and under the same benefit formula), except age.

Lump Sum Based Benefit Formula – A benefit formula under which all or any part of the accumulated benefit is expressed as the current balance of the participant's hypothetical account, or as the current value of the accumulated percentage of the participant's final average compensation.

The determination of a lump sum based benefit formula is not contingent upon whether the plan offers an optional lump sum form of benefit, nor is it determinative whether the participant's accrued benefit at normal retirement age is expressed in the form of an annuity that is actuarially equivalent to the balance of the participant's hypothetical account.

The final regulations confirm that a benefit attributable to after-tax employee contributions, rollovers, and other similar types of employee contributions are disregarded in determining whether a benefit formula is a lump sum based benefit, provided that (1) employee contributions are credited with interest at a rate that does not exceed a reasonable interest rate, and (2) conversion factors used to calculate the benefit based on employee contributions are actuarially reasonable.

Formula with an Effect Similar to a Lump Sum Based Benefit Formula - The final regulations clarify that a benefit formula has an "effect similar to a lump sum-based benefit formula" where the right to future adjustments accrues at the same time as the benefit that is subject to those adjustments. The benefit formula meets this criteria if (1) the formula provides that a participant's accumulated benefit includes the right to periodic adjustments (including indexed benefits described in IRC section 411(b)(5)(E)) for a future period, (2) the total amount of adjustments is reasonably expected to be smaller for the participant when compared to similarly situated younger individuals, and (3) it is based on a comparison of the expected total dollar amount of the adjustments through benefit commencement, rather than the expected total accumulated benefit after application of these adjustments.

A benefit formula that does not include adjustments may still be a formula with an effect similar to a lump sum based benefit formula if benefits are adjusted pursuant to a pattern of repeated plan amendments, and the total dollar amount of those adjustments is reasonably expected to be smaller for the participant than for any similarly situated younger individual.

However, the final regulations confirm that certain adjustments to benefits after annuity commencement date, such as cost of living increases and actuarial increases after normal retirement age, are disregarded in determining whether a formula has an effect similar to a lump sum based benefit formula.

Wearaway – Prior to PPA, when a traditional defined benefit plan converted to a cash balance plan, the amended plan could provide that participants would receive the greater of (a) the frozen accrued benefit under the traditional plan, or (b) the benefit under the cash balance plan. The participant's accrued benefit would not increase until the cash balance benefit exceeded the frozen accrued benefit (i.e., the new cash balance benefit formula would wear away the protected frozen benefit). For conversion amendments adopted after June 29, 2005, PPA requires that a participant's benefit must generally be equal to the sum of the benefits accrued prior to the date of conversion, plus the benefits earned after the conversion, with no interaction between the two (the "A+B Approach"), which effectively assures no "wearaway" period.

Whipsaw – Prior to PPA, statutory hybrid plans were generally required to determine lump sum distributions by projecting the participant's account balance to normal retirement age at the plan's credited interest rate, and then determine the present value by discounting the projected amount at normal retirement age back to a current distribution date, based on a specified interest rate under IRC section 417(e). In Notice 96-8, the IRS also provided for use of several “Safe-Harbor” interest rates that approximate the IRC section 417(e) rate. If the plan’s interest crediting rate exceeded the 417(e) rate or one of the Safe Harbor rates, the present value amount exceeded the participant’s account balance, and this calculation result became known as “whipsaw”. PPA created a new IRC section 411(a)(13)(A) that allows the elimination of whipsaw for distributions after August 17, 2006, and indicates that a lump sum does not fail to meet the requirements under IRC sections 411 and 417 solely because the present value of such benefits is equal to the balance of the hypothetical account, or the current value of the accumulated percentage of a participant’s final average compensation. In final regulations addressing 204(h) notices, the IRS generally requires that participants be given a 204(h) notice 45 days prior to the effective date of the whipsaw elimination.

Vesting

As required by PPA, generally effective for plan years beginning on or after January 1, 2008, participants in statutory hybrid plans must be 100% vested upon completing three years of service. The IRS previously clarified that this rule is applicable to participants who have one hour of service after the effective date, and applies to the participant’s entire account balance, including accruals prior to the effective date. The final regulations confirm that plans with more than one benefit formula (including provisions for an offset among formulas, or a greater of provision), where at least one of the formulas is a statutory hybrid benefit formula, are subject to the three year vesting requirement for all formulas under the plan. This requirement would not apply to a traditional defined benefit plan in a floor offset arrangement.

Safe Harbor for Age Discrimination

The 2010 final regulations adopt the provisions of the 2007 proposed regulations that established a safe harbor for satisfying the age discrimination rules, and require that a participant’s accumulated benefit on any date must not be less than any similarly situated younger participant’s accumulated benefit under the same formula. This safe harbor is applicable to plans under which the accumulated benefit is expressed as (1) an annuity at normal retirement age (or current age, if later), (2) the current balance of a hypothetical account, or (3) the current value of an accumulated percentage of the participant’s final average compensation.

The comparison must be made for each participant to every other similarly situated younger individual who is, or who could be, a participant in the plan using the same benefit formulas (i.e., a participant under formula (1) above cannot be compared to a participant under formula (2) or (3) above). A plan that does not satisfy this test is required to satisfy the general age discrimination rules of IRC section 411(b).

A plan which provides that benefits are based on the “greater of”, or the “sum of”, two benefit formulas, satisfies the safe harbor if each benefit formula independently satisfies the safe harbor. However, if the plan allows older participants to elect the greater of Benefit A and Benefit B, but similarly situated younger participants are entitled to the sum of the same benefits, the plan would not satisfy the safe harbor. Also, if the plan allows older participants to elect a choice of benefits expressed in two or more different forms, but similarly situated younger participants are entitled to the greater of, or the sum of, the same benefits, the plan would not satisfy the safe harbor.

Conversion Protection

As described above, PPA generally forbids the "wearaway" approach for plan conversions. In lieu of the "A+B Approach" described in the definition of wearaway, upon conversion, the 2010 final regulations permit a plan to take advantage of an alternative mechanism which provides for the establishment of an opening hypothetical account balance, based on the traditional plan's accrued benefit. At the time of a participant's retirement, the plan must determine whether the opening balance in the hypothetical account, that is payable in the particular optional form of benefit selected, is greater than or equal to the benefit accrued under the plan prior to the date of conversion, that was payable in the same generalized optional form of benefit. The plan must pay the greater of the two amounts, in addition to the benefit attributable to the post-conversion service under the post-conversion benefit formula.

The 2010 proposed regulations offer an alternative method to satisfy the conversion protection requirements. The alternative method provides for establishing an opening hypothetical account balance, without requiring a subsequent comparison of benefits at the annuity starting date, as long as certain requirements are met, in order to ensure that the opening hypothetical account balance used to replicate the pre-conversion benefit is reasonably expected, in most cases, to provide a benefit at least as large as the pre-conversion benefit for all periods after the conversion amendment (including that the opening hypothetical account balance must not be less than the present value, determined in accordance with IRC section 417(e), of the accrued benefit immediately prior to the effective date of the conversion amendment). It would not be available in situations where the opening balance is the accumulated percentage of the participant's final average compensation, because that method would not be able to reliably replicate the pre-conversion benefit.

This method is also not available for payments other than lump sums. Because of the limited availability of this alternative, plans will still need to keep track of the pre-conversion benefit in order to satisfy the conversion protection requirements for all forms of distributions other than lump sums.

Market Rate of Return Limitation

PPA established a rule that the interest crediting rate under a statutory hybrid benefit formula cannot exceed a market rate of return. The interest crediting rate for a participant generally is the total amount of interest credits for the period, divided by the participant's accumulated benefit at the beginning of the period.

Interest credits must be applied on an annual, or more frequent, periodic basis, and interest credits must be credited at the end of each period. If interest credits are applied over a period that is less than twelve months, the rate for the period cannot be greater than the pro-rata equivalent of the annual interest crediting rate, with specific rules for daily interest crediting. The 2010 final regulations confirm that an interest crediting rate that is compounded more frequently than annually, will not be considered in excess of a market rate of return, simply due to compounded interest.

The 2007 proposed regulations provided that an interest crediting rate that is always less than a particular crediting rate that meets the market rate of return limitation, would not be in excess of the market rate of return. The 2010 final regulations revise this rule, and provide that an interest crediting rate that can never be in excess of a particular rate that meets the market rate of return limitation, is not in excess of the market rate of return. In addition, a statutory hybrid plan may provide participants with credited rates to different predetermined portions of the accumulated benefit, provided that each rate would separately satisfy the market rate of return limitation. However, the 2010 proposed regulations clarify that, in certain limited circumstances, a plan can provide interest credits that are based on the greater of two or more rates, without exceeding a market rate of return.

The 2010 final regulations specify several safe harbor rates of interest, including (a) interest rate on 30-year Treasury securities, (b) interest rate on shorter-term Treasury securities with associated margins, (c) the first, second or third segment rate under IRC section 430(h) or IRC section 417(e), (d) eligible cost of living indices with associated margins, (e) for an indexed plan, the actual rate of return on plan assets, so long as the plan satisfies ERISA's diversification requirements, and (f) the actual rate of return on individual annuity contracts.

The 2010 proposed regulations expand the list of safe harbor rates to include (a) for any type of hybrid plan, the plan's actual market rate of return, provided that plan assets meet ERISA's diversification requirements, (b) the rate of return on a registered investment company (mutual fund) that is not significantly more volatile than the broad United States equities market or a similar broad international equities market, (c) a minimum interest crediting rate of 4% (used with a permissible bond rate), (d) a fixed annual rate of 5% or less, and (e) a cumulative floor rate of 3% or less (applied to equity- based or bond-based rates).

The 2010 final regulations provide a preservation of capital rule that requires a statutory hybrid plan to ensure that interest credits do not result in a hypothetical account balance (or similar amount) being less than the aggregate amount of hypothetical allocations. The final regulations clarify that the preservation of capital rule applies to all principal credits that were credited under the plan as of the annuity starting date (including principal credits that were applied prior to the effective date of PPA).

Protected Benefits - Change in Plan's Interest Crediting Rate

The 2010 final regulations reflect the general rule that benefits that have already accrued under a statutory hybrid plan are protected benefits in accordance with IRC section 411(d)(6), including the right to interest credits in the future that are not conditioned on future service. Therefore, an amendment to change a plan's interest crediting rate must generally satisfy IRC section 411(d)(6) if the revised rate, under any circumstance, could result in interest credits that are smaller, as of any date after the applicable amendment date.

However, the 2010 final regulations provide that, if a plan amendment changes the interest crediting rate on future interest credits from one of the bond-based safe harbor rates in the 2010 final regulations, to the rate of interest on long-term investment grade corporate bonds (i.e., the third segment rate under IRC section 417(e) or 430(h)), it will not result in a violation of the protected benefit rules if (1) the change only applies to interest credits made after the effective date of the amendment, (2) the amendment is effective at least thirty days after it is adopted, and (3) the new interest crediting rate is not lower than the prior interest crediting rate on the effective date of the amendment.

The 2010 proposed regulations provide that, when an amendment changes the plan's interest crediting rate, and neither the old rate, nor the new rate, exceeds the market rate of return, the plan's effective interest crediting rate is deemed to not be in excess of the market rate of return, merely because the plan provides for the benefit of any participant who is benefiting under the plan on the applicable amendment date to never be less than what it would be if the old rate had continued, but without taking into account any principal credits after the applicable amendment date.

The IRS indicated that it expects to grant additional anti-cutback relief under IRC section 411(d)(6), in order for plans that currently have a rate deemed to be in excess of a market rate of return, to change to a rate which satisfies the market rate of return requirement, as long as certain conditions are met, including that the change to the interest crediting rate would be no more than necessary to satisfy the market rate requirement. The 2010 proposed regulations indicate that the amendment must be adopted before the 2010 proposed regulations are finalized.

Whipsaw Relief for Lump Sum Distributions, and Certain Distributions Other Than Lump Sums

As explained above, PPA allows hybrid plans to pay a lump sum benefit equal to the hypothetical account balance without first applying a "whipsaw" calculation. The 2010 proposed regulations provide more detail on the criteria for relief under IRC section 411(a)(13)(A) and establish additional requirements for statutory hybrid plans with lump sum based benefit formulas to be able to pay the hypothetical account balance as a lump sum:

(1) The plan must at all times on or before normal retirement age have a hypothetical account balance, or an accumulated percentage of the participant's final average compensation, that is

equal to or greater than the present value (using reasonable actuarial assumptions) of the portion of the participant's accrued benefit that is determined under the lump sum based benefit formula.

(2) For a plan that does not suspend benefits in accordance with the Department of Labor (DOL) suspension of benefits rules, the plan must provide for an interest crediting rate after normal retirement age, such that the rules regarding post-normal retirement age accruals are satisfied by the combination of principal credits and interest crediting rate. The proposed regulations further clarify that a plan will not be treated as providing an interest crediting rate in excess of a market rate of return, if the plan ensures that it credits a rate that is sufficient to provide any required actuarial increase.

(3) The balance of the hypothetical account, or the accumulated percentage of the participant's final average compensation, may not be reduced, unless it is due to (a) benefit payments, (b) a Qualified Domestic Relations Order, (c) permitted forfeitures (such as charges for providing a qualified pre-retirement survivor annuity), (d) amendments permitted under the IRS anti-cutback rules of IRC section 411(d)(6), and (e) adjustments resulting from the application of negative interest credits for plans that express the accumulated benefit as a percentage of a hypothetical account balance.

Further relief under IRC section 411(a)(13)(A) is provided (but not required) in the 2010 proposed regulations for certain forms of distributions other than lump sums if the plan satisfies the criteria in the above paragraphs (1) through (3), and if the optional form of benefit at the annuity starting date is determined as the actuarial equivalent (using reasonable actuarial assumptions) of the balance of the hypothetical account, or the accumulated percentage of the participant's final average compensation.

Plan Termination

The 2010 proposed regulations provide guidance regarding the interest crediting rates and annuity conversion rates that apply when a plan is terminated.

Effective Dates and Amendment Deadlines

Except for vesting and certain other PPA provisions that require earlier effective dates, the provisions of the 2010 final regulations are generally effective for plan years beginning on or after January 1, 2011. The provisions of the 2010 proposed regulations are generally effective for plan years beginning on or after January 1, 2012. The final and proposed regulations relating to interest crediting rates are proposed to be effective for plan years beginning on or after January 1, 2012. However, plans are permitted to rely on the provisions of these final and proposed regulations in the interim, as well as the provisions of the 2007 proposed regulations, and IRS Notice 2007-6.

On November 30, 2010, the IRS issued Notice 2010-77, which extends the deadline for amendments to comply with, among other things, certain provisions of PPA and related regulations affecting hybrid defined benefit plans. The adoption deadline was extended to the end of the 2011 plan year for these specific hybrid plan amendments (relating to vesting and certain other hybrid plan issues), but the plan must continue to satisfy operational compliance in accordance with the provisions. The IRS has extended that deadline twice, and most recently IRS Notice 2012-61 has extended the deadline to plan years beginning on or after January 1, 2014.

If MassMutual provides plan document and/or actuarial services for your plan, we will work with you to ensure that your plan is compliant with the final and proposed regulations. If MassMutual does not provide plan document and/or actuarial services for your plan, you should contact your ERISA attorney and/or your actuary to discuss these issues.

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