

# IRS Releases Proposed Cash Balance Plan Regulations Allowing Equity-Based Rates of Return

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**Brief Description:** This article focuses on issues related to one significant new provision in the proposed hybrid DB plan regulations, allowing for the use of equity-based crediting rates.

On October 18, 2010, the IRS released final and proposed regulations with respect to hybrid defined benefit (DB) plans, including cash balance plans. The rules under both the final regulations and the proposed regulations are very technical, and deal in detail with a variety of issues – including some issues that apply in only a limited number of situations (e.g., the treatment of variable annuities).

In this article, we assume that plan sponsors have generally been aware of the post-PPA rules regarding cash balance plans for some time. We are not going to review either the final regulations or the 2010 proposed regulations in detail. Instead, this article will focus on issues related to one significant new provision in the proposed regulations allowing for the use of equity-based crediting rates.

## Background

In this article, we assume a general familiarity with basic cash balance plan operations and terminology. We do, however, want to explicitly review some cash balance plan terminology that may be confusing. In this article we'll be speaking about cash balance plans, understood generally as DB plans that describe a participant's benefit in terms of the value of a hypothetical account to which pay credits (hypothetical "contributions") and interest credits (hypothetical "earnings") are made. While "interest credits" is a generally accepted cash balance term (as we use it at least) interest credits don't literally have to involve "interest." For instance, interest credits could be based on gains and losses on a hypothetical (or actual) equity portfolio. And in some circumstances those equity-based interest credits could be negative; that is, they could reduce the value of a participant's account.

Prior to passage of the Pension Protection Act of 2006 (PPA), many cash balance plan sponsors used a safe harbor interest crediting rate based on a bond or Treasury instrument index to determine interest credits. This was done to avoid certain regulatory issues (principally "whipsaw", where a plan might be required to pay a lump sum larger than a participant's current account balance). PPA allows the use of any interest crediting rate that is not in excess of a "market rate of return," clearly contemplating the possibility that a plan might base interest credits on an equity index. PPA also added a "preservation of capital" requirement, generally requiring that a participant's benefit at commencement be no less than the sum of all pay credits, thus putting a "floor" on losses that could be "credited" to an account.

In 2007, the IRS issued proposed regulations that refined the list of fixed income crediting rates plans could use, but deferred the issue of what sorts of equity-based crediting rates could be used without violating either the market rate of return or preservation of capital rules. The 2010 proposed regulations address this issue, providing a specific set of rules for what sorts of equity-based returns may be used. They also provide rules with respect to permitted return "floors," minimums, and fixed rates of return that may be used.

## Equity-Based Rates of Return

Generally, under the 2010 proposed regulations, a plan may (in addition to previously identified fixed income crediting rates) use either of the following as the interest crediting rate:

**Return on plan assets.** The actual rate of return on plan assets, provided that the plan's assets are diversified so as to minimize the volatility of returns. (The requirement that plan assets be

diversified so as to minimize volatility of returns does not require greater diversification than is required under ERISA section 404(a)(1)(C).

**Return on a regulated investment company.** The rate of return on a regulated investment company that is reasonably expected to be not significantly more volatile than the broad United States equities market or a similarly broad international equities market. Examples of regulated investment companies that qualify could include those that track the rate of return on the S&P 500, a broad-based "small-cap" index (such as the Russell 2000 index), or a broad-based international equities index.

So, under the proposed regulations, cash balance plans may now use an equity-based rate of return, so long as it is not too volatile.

## "Floors," Minimums, and Fixed Rates

One of the issues left open in the 2007 proposed regulations was how an equity based rate of return could comply with both the market rate and capital preservation rules. The obvious reason for limiting the volatility of equity-based rates of return was to avoid use of a highly volatile index with a guaranteed floor – a combination that would likely exceed a market rate of return.

The 2010 proposal also includes new rules as to what sorts of floors on returns, minimum returns, and fixed returns may be used. Generally:

With respect to safe harbor fixed income rates of return, a plan may provide for an annual floor rate not exceeding 4%.

With respect to equity-based rates of return, a plan may provide for a cumulative floor not exceeding 3%.

A plan may provide for a fixed rate of return not exceeding 5%.

We note that the general rule is that returns may not be in excess of a market rate of return. Thus, under the final regulations, plans may provide for an interest crediting rate that is less than a safe harbor interest crediting rate. For example, a plan could credit a specific fraction (e.g., 90%) of a safe harbor interest crediting rate.

## When Does the New Rule Apply?

If finalized, the 2010 proposed regulations would apply to plan years that begin on or after January 1, 2012. However, a plan is permitted to rely on the proposed regulations for periods before the regulatory effective date. So, in effect, a sponsor could implement an equity-based rate of return (or a minimum or floor, etc.) today. Obviously, roll-out of such a program will take some preparation, but as a general matter sponsors may begin the process of implementing it immediately.

## Transitioning to an Equity-Based Rate

Many sponsors of cash balance plans are currently providing interest credits at a safe harbor rate, or a rate that would be considered safe harbor with some adjustments. For example, a plan that currently credits interest at the 30-year Treasury rate with an annual floor of 4.5% may need to be amended to reduce the floor on a prospective basis so the crediting rate complies with the market rate of return rules.

For plans that are already using a safe harbor rate, changing to a different rate (e.g., an equity-based rate) is generally not simple because the interest crediting rate is considered a protected part of a participant's accrued benefit. The ability to accrue interest credits at the old rate must be preserved for pay credits in participants' accounts prior to the change to equity-based rates.

If you want to move all old money to a new equity-based rate, you can "wear away" the old benefit. Generally, this would involve running: (1) an old account equal to the account balance as of the date of amendment plus "old" interest credits thereafter; and (2) a new account equal to the account balance as of the date of amendment plus future pay credits and equity-based interest credits thereafter; and providing the participant the greater of (1) and (2). At some point (2) will likely be greater than (1) for most participants. This approach will, at a minimum, present some administrative complexity and a communications challenge.

Alternatively, a simpler approach would be to continue to provide old interest credits on old money and new equity-based credits on new money.

## Like a 401(k) Plan?

Much of the demand for equity-based credits in cash balance plans derives from a sponsor (and participant) preference for 401(k)-style investing in those plans. We would expect that some plan sponsors who implement equity-based credits will want to give participants a choice between equity-based credits and a fixed income credit. The proposed regulations do not explicitly allow for participant investment choice within a cash balance arrangement, but the preamble to the regulations requests comments on this issue. In the meantime, the proposed regulations would allow a plan sponsor to provide a specified mix of equity and fixed income credits (e.g., a plan sponsor could credit equity credits on 2/3 of a participant's account and fixed income credits on 1/3 of a participant's account).

Sponsors will want to consider the administrative complexity – running, in effect, multiple accounts for different time periods each using different crediting rates – of allowing participant choice or crediting a blended rate.

If final regulations allow participant investment choice in cash balance plans, it is unlikely that sponsors will want to allow frequent changes (e.g., daily, weekly, or even monthly) given the complexity of moving from one interest crediting basis to another. As a practical matter, it is difficult to imagine providing participants with the same flexibility in changing investments that they currently enjoy under 401(k) plans.

## Conclusion

The final and proposed regulations include comprehensive rules with respect to the design and operation of cash balance plans. The deadline for amendments to bring plans into compliance is generally the last day of the first plan year that begins on or after January 1, 2010. However, the deadline for amendments to bring plans into compliance with the market rate of return rules is extended to the last day of the 2011 plan year.

In this article, we have focused on the issues related to the adoption and implementation of equity-based rate of return provisions. Sponsors of cash balance plans will want to consult with their legal and tax advisers and their actuary concerning this issue and concerning general compliance with the new rules.



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