New Final and Proposed Regulations on Cash Balance and Other Hybrid Plans

December 2014
This Aon Hewitt report provides a detailed summary of the key provisions of the 2014 final and proposed regulations and is organized by topic as follows:

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Each topical section addresses both the final and proposed regulations published in 2014.
New Final and Proposed Regulations on Cash Balance and Other Hybrid Plans

The Pension Protection Act of 2006 (PPA) added several important provisions to the Internal Revenue Code (Code), the Employee Retirement Income Security Act (ERISA), and the Age Discrimination in Employment Act (ADEA) aimed specifically at cash balance and other hybrid defined benefit pension plans. PPA was subsequently amended by the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA) in certain respects applicable to hybrid defined benefit pension plans.

On September 19, 2014, final and proposed regulations regarding hybrid defined benefit plans were published in the Federal Register. These new regulations modify and expand on prior final and proposed regulations that were published in the Federal Register on October 18, 2010. The 2010 final regulations dealt primarily with age discrimination issues, including rules applicable to conversions of traditional defined benefit pension plans to hybrid plans. The 2010 proposed regulations dealt primarily with interest crediting rates not exceeding a market rate of return.

The 2014 final regulations are largely consistent with the 2010 final and proposed regulations, but include a number of clarifications and other modifications relating to:

- Payment of the account balance as a lump sum (i.e., “whipsaw relief”);
- Definitions of lump-sum based benefit formulas, formulas with an effect similar to a lump-sum based formula, and variable annuity formulas;
- Age discrimination safe harbor (i.e., the “similarly situated” test);
- Conversion of a traditional defined benefit plan to a cash balance or other hybrid defined benefit plan; and
- Market rate of return limitation on interest crediting rates.

The 2014 proposed regulations deal primarily with guidance to transition impermissible interest crediting rates to satisfy the requirements not to exceed a market rate of return, as provided in the 2014 final regulations.

Comments on the proposed regulations must be received by December 18, 2014. A public hearing on the proposed regulations is scheduled for January 9, 2015. Outlines of topics to be discussed at the public hearing must be received by December 18, 2014.
Interest Crediting Requirements

Under PPA, a statutory hybrid plan must not provide an interest crediting rate greater than a market rate of return. Otherwise, the plan is deemed to be age discriminatory. Effective for plan years beginning on or after January 1, 2016 (or an earlier date elected by the taxpayer), a plan is not treated as failing to meet this requirement merely because the plan does not provide for interest credits on amounts distributed prior to the end of the interest crediting period. The 2010 final regulations defined what is meant by interest credits, and listed certain specific interest crediting rates that are considered to meet the market rate of return requirements. The 2014 final regulations expand on this list of acceptable interest crediting rates, and allow for certain minimum rates discussed under the section Combination of Rates of Return. All other additions to a participant’s accumulated benefit that do not meet the definition of interest credits are considered principal credits (e.g., pay credits), regardless of what they are called under the terms of the plan.

Interest Credits Defined

The 2010 final regulations defined interest credits as adjustments to a participant’s accumulated benefit not conditioned on current service and not made on account of imputed service due to:

- Any increase or decrease, based on the terms of the plan at the start of a period, calculated by applying a rate of interest or rate of return (including a rate based on an index) to all or a portion of the accumulated benefit at the start of the period; or
- Any other increase, based on the terms of the plan at the start of a period, for such period.

A one-time increase in an accumulated benefit resulting from a plan amendment is not treated as an interest credit. However, a pattern of repeated plan amendments providing for one-time adjustments will be treated as providing increases on a permanent basis under the terms of the plan, presumably as permanent interest credits.

Permissible Interest Credits

Like the 2010 regulations, the 2014 final regulations provide that only interest crediting rates specifically allowed for under the regulations are considered to meet the market rate of return requirements (i.e., the regulations provide an exclusive list of acceptable crediting rates). However, the new final regulations include certain important changes from the 2010 regulations. A statutory hybrid plan is considered to be age discriminatory if its interest crediting rate exceeds a market rate of return. Note that the final regulations make no inference regarding permissible interest crediting rates for periods prior to the effective dates of the regulations. Thus, even if a plan credits interest at a rate that would not meet the requirements of the final regulations, the interest crediting rate could still satisfy the statutory requirement not to provide interest credits in excess of a market rate of return for periods prior to the regulatory effective dates.

Effective for plan years beginning on or after January 1, 2016 (or an earlier date elected by the taxpayer), the 2014 final regulations specify the following interest crediting rates as deemed not to exceed a market rate of return for single rates:
Segment Rates
The first, second, or third segment rate described in Code Section 417(e)(3) or 430(h)(2)(C), with or without regard to the transition rules of Code Section 417(e)(3)(C)(ii) or 430(h)(2)(G), and with or without regard to the interest rate stabilization provisions enacted under the Moving Ahead for Progress in the 21st Century Act (MAP-21) or the Highway and Transportation Funding Act of 2014 (HATFA).

Bond Rates
Rates equal to the sum of a bond interest rate plus the associated margin as set forth in the table below.

<table>
<thead>
<tr>
<th>Interest Rate Bond Index</th>
<th>Associated Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount rate on 3-month Treasury Bills</td>
<td>175 basis points</td>
</tr>
<tr>
<td>Discount rate on 12-month or shorter Treasury Bills</td>
<td>150 basis points</td>
</tr>
<tr>
<td>Yield on 1-year Treasury Constant Maturities</td>
<td>100 basis points</td>
</tr>
<tr>
<td>Yield on 3-year or shorter Treasury bonds</td>
<td>50 basis points</td>
</tr>
<tr>
<td>Yield on 7-year or shorter Treasury bonds</td>
<td>25 basis points</td>
</tr>
<tr>
<td>Yield on 30-year or shorter Treasury bonds</td>
<td>0 basis points</td>
</tr>
</tbody>
</table>

Cost-of-Living Index
Cost-of-living indices equal to the rate of increase with respect to an eligible cost-of-living index described in Treasury regulation Section 1.401(a)(9)-6, A-14(b), except that the index described in Treasury regulation Section 1.401(a)(9)-6, A-14(b)(2) may be increased by up to 300 basis points; provided the rate is adjusted at least annually.

Return on plan assets
Actual rate of return on plan assets, including both positive and negative returns (subject to the preservation of capital requirement discussed below), provided the plan’s assets are diversified so as to minimize the volatility of returns. Diversification does not need to be greater than that required by ERISA Section 404(a)(1)(C) for defined benefit plans.

A plan may credit the rate of return on a subset of plan assets rather than the return on all plan assets if certain additional requirements are met. Specifically, the aggregate fair market value of qualifying employer securities (within the meaning of ERISA Section 407) in the subset cannot exceed 10% of the fair market value of assets in the subset. In addition, the fair market value of assets in the subset must approximate the liabilities for benefits adjusted by reference to the return on assets in the subset, determined using reasonable actuarial assumptions.
Annuity Contract Rates

The rate of return on an annuity contract issued to an employee by an insurance company licensed under the laws of a state, provided the Internal Revenue Service (IRS) does not subsequently determine the contract is structured to provide an interest crediting rate in excess of a market rate of return.

Fixed Rate of Interest

The 2014 final regulations provide that an annual interest crediting rate of up to 6% is not in excess of a market rate of return. This maximum permissible fixed interest rate has been increased from 5% in the 2010 proposed regulations.

Rate of Return on Certain Regulated Investment Companies

The 2014 final regulations provide that an interest crediting rate is not in excess of a market rate of return if it is equal to the rate of return on a regulated investment company (RIC), as defined in Code Section 851 (e.g., a mutual fund), that is reasonably expected to be not significantly more volatile than the broad U.S. equities market or a similarly broad international equities market. The regulations indicate that a RIC with most of its assets invested in securities of issuers (including other RICs) concentrated in an industry sector or a country other than the United States, that uses leverage, or that has significant investment in derivative financial products, for the purpose of achieving returns that amplify the returns of an unleveraged investment, generally would not satisfy this requirement. A RIC whose investments track the rate of return on the S&P 500, a broad-based “small-cap” index, or a broad-based international equities index would satisfy this requirement. Note that the regulations do not allow the use of the return on an index such as the S&P 500 rather than the return on an actual RIC.

Exclusive List May Be Expanded in Future Guidance

The 2014 final regulations provide that the IRS may publish future guidance in the Internal Revenue Bulletin that provides for additional interest crediting rates that are considered to meet the market rate of return requirements. The IRS may also publish guidance that increases the maximum permissible margins over Treasury bond rates, the maximum permissible fixed interest crediting rate, or the maximum permissible crediting rate floors (discussed under the section Combination of Rates of Return).

Timing and Other Rules of Application

The plan must specify the method for determining interest credits and the frequency of interest crediting. A plan can determine interest credits for each current interest crediting period based on the effective periodic interest crediting rate that applies over that period. The rules regarding the method for determining interest credits and the frequency of interest crediting are generally effective for plan years beginning on or after January 1, 2011. The 2014 final regulations did not expressly provide for a delayed effective date for this requirement, except with respect to debits and credits during the interest crediting period. Additionally, the 2014 final regulations did not provide for a delayed effective date for the lesser-of and blend blended rate rules of this subsection on Timing and Other Rules of Application. However, the transition rules in the 2014 proposed regulations would permit a plan sponsor to correct non-compliant timing rules for determining interest credits to bring the plan into compliance with the final regulations, and provide an example illustrating this.
Stability Period and Lookback Month

If using one of the segment rates, bond rates, or cost-of-living indices listed above or a fixed rate not exceeding 6%, a plan can alternatively determine interest credits for a stability period based on the interest crediting rate for a specified lookback month. The stability period and lookback month must satisfy the rules for selecting the stability period and lookback month under Treasury regulation Section 1.417(e)–1(d)(4). However, the interest crediting rate can be any one of the rates listed in the prior sentence and the stability period and lookback month need not be the same as those used under the plan for purposes of Code Section 417(e)(3).

Frequency of Interest Crediting

Interest credits must be provided at least annually and credited as of the end of the crediting period. If credited more frequently than annually, the interest crediting rate for the less than annual period must be no more than a pro rata portion of the annual interest crediting rate to not exceed a market rate of return. However, the 2010 final regulations permit a daily interest crediting rate of 1/360 of the corresponding annual interest crediting rate for plans that credit interest daily and use one of the segment rates or bond rates listed above, and the 2014 regulations do not change this provision. The regulations expressly permit compounding of interest credits provided more frequently than annually only for a plan using one of the segment rates, bond rates, or cost-of-living indices listed above or a fixed rate not exceeding 6%.

Rates Less Than Those Specified in the Regulations

An interest crediting rate is not in excess of a market rate of return if the rate can never exceed a particular interest crediting rate described above. For example, an interest crediting rate defined to equal the lesser of a fixed 6% interest rate or the yield on 30-year Treasury bonds would not exceed a market rate of return.

Blended Rates

A statutory hybrid plan does not provide an interest crediting rate in excess of a market rate of return merely because the plan determines an interest credit by applying different interest crediting rates to different predetermined portions of the accumulated benefit, provided each rate would separately satisfy the requirements for a single interest crediting rate, described above, if the rate applied to the entire accumulated benefit. While not explicitly stated in the regulations, this would appear to permit a plan to credit the average of two or more interest crediting rates, each of which would satisfy the requirements for a single interest crediting rate.

Principal Credits

The 2010 final regulations define principal credits (e.g., pay credits) as any increase in a participant’s accumulated benefit that is not due to an interest credit, regardless of how the increase is characterized under the terms of a plan, and the 2014 regulations do not change this definition. Increases conditioned on current service or made on account of imputed service, including a one-time increase such as an opening account balance, and increases in the value of an accumulated percentage of final average compensation, such as under a pension equity plan, are principal credits rather than interest credits. The distinction between principal credits and interest credits is important in determining whether a plan satisfies the PPA preservation of capital requirement. For instance, if a plan provides additional interest
credits for a limited period of time, those are likely principal credits. These rules are effective for plan years beginning on or after January 1, 2011.

**Preservation of Capital Requirement**

A statutory hybrid plan must provide that a participant's benefit under the hybrid benefit formula, determined as of the participant's annuity starting date, is not less than the benefit based on the sum of all principal credits provided under the plan to the participant as of the annuity starting date, including principal credits provided prior to the applicable statutory effective date. This requirement does not apply in the case of a benefit provided under a variable annuity benefit formula (defined under the section Three-Year Minimum Vesting Requirements).

The 2014 final regulations provide rules of application when there are multiple annuity starting dates for a participant, which are effective for plan years beginning on or after January 1, 2016 (or an earlier date elected by the taxpayer). If a participant has more than one annuity starting date, the sum of all principal credits provided under the plan to the participant as of the current annuity starting date is compared to the sum of:

- The participant’s benefit as of the current annuity starting date;
- The amount of the offset to the participant’s benefit under the statutory hybrid benefit formula that is attributable to any prior distribution of the participant’s benefit under that formula; and
- The amount of any increase to the participant’s benefit as a result of this rule to any prior distribution.

If the comparison results in the sum of all principal credits as of the current annuity starting date exceeding the above sum, then the participant’s benefit to be distributed at the current annuity starting date must be increased by an amount equal to the excess.

**Combinations of Rates of Return**

The regulations only permit combinations of rates of return involving greater-of comparisons. Presumably, sums, differences, or other combinations of rates of return would be viewed as producing effective rates that are in excess of a market rate of return and, thereby, violating age discrimination prohibitions. The 2014 final regulation rules regarding combinations of rates of return are effective for plan years beginning on or after January 1, 2016 (or an earlier date elected by the taxpayer).

**Greater-of Rates**

An effective interest crediting rate determined by applying the greater of two or more different single rates to the accumulated benefit is considered to meet the market rate of return rules only if each of the different single rates would separately satisfy the requirements for single rates described above and the requirements for combinations of rates described below are also satisfied.

A plan is not treated as providing the greater of two or more interest crediting rates merely because the plan defines an interest credit on a basis other than the interest crediting rates specified above or because the rate of return on an annuity contract issued to an employee by an insurance company licensed under the laws of a state is itself based on the greater of two or more rates.

The 2014 final regulations provide that interest credits based on the greater of two or more different interest crediting rates are in excess of a market rate of return unless the greater-of rate consists of: (1) a
bond-based rate with a fixed rate floor that is applied in each interest crediting period; or (2) an
investment- or bond-based rate with a fixed rate floor that is applied at benefit commencement rather than
in each interest crediting period. The maximum permissible fixed rate floor varies based on the underlying
variable rate as described below.

**Fixed 4% or 5% Floor Applied to Bond-Based Rates**—The plan may provide that the interest crediting
rate for an interest crediting period equals the greater of one of the corporate bond segment rates,
Treasury bond-based rates, or cost-of-living indices listed above and an annual interest rate not
exceeding the following (or a pro rata portion thereof, if the plan provides interest credits more frequently
than annually):

- 4%, if the plan provides interest credits based on one of the corporate bond segment rates.
- 5%, if the plan provides interest credits based on a Treasury bond-based rate or a cost-of-living
  index.

**Fixed 3% Floor Applied to Investment-Based or Bond-Based Rates**—A plan that uses one of the
corporate bond segment rates, Treasury bond-based rates, annuity contract rates, or cost-of-living indices
listed above or the return on plan assets, return on a RIC, or an interest crediting rate that can never
exceed one of those rates may provide that a participant’s benefit under the statutory hybrid benefit
formula determined as of the participant’s annuity starting date is equal to the greater of:

- The benefit determined using the interest crediting rate; and
- The benefit determined as if the plan had used a fixed annual interest crediting rate not exceeding 3%
  for all principal credits that are made during the guarantee period (which is the “minimum guarantee
  amount”).

The “guarantee period” is the prospective period beginning on the date the cumulative floor begins to
apply to the participant’s benefit and ending on the date on which that cumulative floor ceases to apply to
the participant’s benefit. The determination is made only at an annuity starting date on which a distribution
of the participant’s entire benefit under the plan’s statutory hybrid benefit formula (as of that annuity
starting date) commences. If a participant has more than one annuity starting date, the minimum
guarantee amount, as of the current annuity starting date, is compared to the sum of:

- The participant’s benefit, as of the current annuity starting date, to which the minimum guaranteed
  rate applies;
- The amount of the offset to the participant’s benefit under the statutory hybrid benefit formula that is
  attributable to any prior distribution of the participant’s benefit under that formula and to which the
  minimum guaranteed rate applied, together with interest at that minimum guaranteed rate annually
  from the prior annuity starting date to the current annuity starting date; and
- The amount of any increase to the participant’s benefit as a result of this rule to any prior distribution,
  together with interest annually at the minimum guaranteed rate that applied to the prior distribution
  from the prior annuity starting date to the current annuity starting date.

If the comparison results in the minimum guarantee amount as of the current annuity starting date
exceeding the above sum, then the participant’s benefit to be distributed at the current annuity starting
date is increased by an amount equal to the excess. If the cumulative floor applies to a portion of a
participant’s benefit, only the principal credits that are attributable to that portion of the participant’s
benefit are taken into account in determining the minimum guarantee amount.
**Aon Hewitt Comment:** The purpose of the comparison described above is to ensure that the guarantee provided to a participant is not effectively increased or reduced as a result of prior distributions. For example, suppose that Participant A participates in a plan that provides investment-based interest credits with a cumulative floor of 3%. Further suppose that A has received a prior distribution of a portion of his accrued benefit and that the effective interest rate he had earned as of the distribution date was 5%. Unless the comparison described above is performed when A commences the remainder of his benefit, he will effectively have been provided a guarantee in excess of 3% on his total benefit because the prior distribution would not have been adjusted for subsequent investment performance. Similarly, if the effective interest rate A had earned as of the distribution date was negative 5%, he will effectively have been provided a guarantee of less than 3% on his total benefit.

### Changing Interest Crediting Rates

An amendment to change a plan’s interest crediting rate with respect to benefits already accrued as of the date of the amendment must generally satisfy the anti-cutback rules of Code Section 411(d)(6) if the revised rate, under any circumstances, could result in interest credits with respect to benefits accrued prior to the amendment date that are smaller as of any date after the applicable amendment date than the interest credits that would be provided without regard to the amendment. However, Section 1107 of PPA provides relief under Code Section 411(d)(6) for an amendment that reduces a plan’s interest crediting rate to the extent such a reduction is required for the plan to satisfy the PPA market rate of return requirements. The 2014 final regulations provide for certain changes in interest crediting rate that are considered to satisfy the requirements of Code Section 411(d)(6), while the 2014 proposed regulations provide for specific transition approaches for changes needed to bring a plan’s interest crediting rate into compliance with the final market rate of return regulations.

**Aon Hewitt Comment:** Even if an amendment to bring a plan’s interest crediting rate into compliance with the final market rate of return regulations does not create a Code Section 411(d)(6) cutback, an ERISA Section 204(h) notice may be required if the amendment is reasonably expected to result in a reduction in the rate of future benefit accrual under the plan. An ERISA Section 204(h) notice could even be required for an amendment that reduces the interest crediting rate only for future cash balance principal credits or pension equity benefit accumulations.

### Safe Harbor Change to Third Segment Rate

A plan that provides interest credits using the first or second segment rate, a bond rate, an annuity contract rate, a cost-of-living index listed above, or a fixed rate not exceeding 6% may be amended to credit interest using the third segment rate without creating a Code Section 411(d)(6) cutback issue provided that all four of the following conditions are satisfied:

- The amendment only applies to interest credits credited after the effective date of the amendment;
- The effective date of the amendment is at least 30 days after adoption of the amendment;
- On the effective date of the amendment, the new interest crediting rate is not lower than the interest crediting rate that would have applied in the absence of the amendment; and
- For plan years beginning on or after January 1, 2016, if a plan provided for a fixed annual floor with the prior interest crediting rate, the floor must be retained to the maximum extent permissible under the final regulations.
"Wearaway" Approach

Under the 2014 final regulations, effective for plan years beginning on or after January 1, 2016 (or an earlier date elected by the taxpayer), a plan is not treated as providing an interest crediting rate in excess of a market rate of return merely because the plan is amended to change interest crediting rates on a prospective basis from one rate that does not exceed a market rate of return to another such rate using a "wearaway" approach. Under this approach, the plan would provide that a participant’s benefit is the greater of: (1) the benefit determined based on the new interest crediting rate and including any principal credits following the amendment; and (2) the benefit determined based on the old interest crediting rate without taking into account any principal credits following the amendment, thereby "wearing away" the benefit under (2) as the benefit under (1) increases. However, a pattern of repeated plan amendments changing the interest crediting rate from one basis to another will be treated as though the ongoing plan terms provide for the interest crediting rate to equal the greater of each of the interest crediting rates. In this situation, the exception described in this paragraph would not apply and the general rules for combinations of rates of return described above would apply instead. Note that while such a wearaway approach would be permissible for active participants, it would not generally be permissible for terminated participants, as a plan that provides the greater of two interest crediting rates on the same portion of a participant’s accumulated benefit could be considered to provide in excess of a market rate of return.

Change in Lookback Month or Stability Period

Under the 2014 final regulations, effective for plan years beginning on or after January 1, 2016 (or an earlier date elected by the taxpayer), if a plan provides an interest crediting rate based on one of the corporate bond segment rates, a Treasury bond rate, or a cost-of-living index listed above which requires the use of a lookback month and stability period, the plan may be amended to change the lookback month or stability period using a one-year grandfathering approach similar to the approach required for changes in lookback month and stability period under Code Section 417(e)(3). If the amendment is effective on or after the adoption date, interest credits for the one-year period beginning on the effective date must be determined using the lookback month and stability period that produces the larger interest credits. If the amendment is adopted retroactively, the plan must provide interest credits using the lookback month and stability period that produces the larger interest credits for the period beginning with the effective date and ending one year after the adoption date. Further, the 2014 final regulations caution that a pattern of repeated plan amendments changing the lookback or stability period used to determine interest credits will be treated as though the ongoing plan terms provide for an effective interest crediting rate that exceeds a market rate of return.

RIC That Ceases to Exist

Under the 2014 final regulations, effective for plan years beginning on or after January 1, 2016 (or an earlier date elected by the taxpayer), if a plan provides an interest crediting rate based on the rate of return on a RIC, and the RIC subsequently ceases to exist, a successor RIC may be used to determine interest credits for subsequent periods. If the RIC ceases to exist due to a name change or merger, the successor RIC must be the RIC resulting from the name change or merger. In all other cases, the successor RIC must be a RIC selected by the plan sponsor that has reasonably similar characteristics, including risk and return, as the RIC that ceases to exist.

Aon Hewitt Comment: In situations where a plan sponsor wishes to change the RIC used to determine interest credits for reasons other than the RIC ceasing to exist, such as poor investment performance or a change in investment strategy, the final regulations would require the plan sponsor
to protect the accrued benefit based on the prior crediting rate as discussed below. As a result, the plan sponsor would need to either change the crediting rate for future principal credits only, or apply a wearaway approach for active participants.

Other Changes in Crediting Rate Not Required to Comply With Final Regulations

The 2014 final regulations provide that the interest crediting rate is a factor used to determine a participant’s accrued benefit for purposes of Code Section 411(d)(6), rather than a protected part of the accrued benefit per se. As a result, a plan could potentially be amended to provide smaller future interest credits on a participant’s current accumulated benefit. However, in situations other than a change in interest crediting rate that is required to bring the interest crediting rate into compliance with the final market rate of return regulations, the amendment would also need to provide increased benefits in some other manner to ensure that the smaller future interest credits do not result in a smaller accrued benefit.

_Aon Hewitt Comment:_ While this language in the 2014 final regulations appears to provide plan sponsors with the flexibility to amend a plan to reduce the interest crediting rate, in practice it would be difficult for such an amendment to also provide additional benefits in such a manner as to ensure that a participant’s accrued benefit cannot decrease due to the change. As a result, plan sponsors wishing to reduce the interest crediting rate will likely need to protect the interest crediting rate on a participant’s existing accumulated benefit in most situations.

Changes in Interest Crediting Rate Required to Comply With Final Regulations

The proposed regulations provide rules regarding the transition from an interest crediting rate that does not meet the market rate of return requirements of the final regulations to a crediting rate that does meet the requirements. Each noncompliant feature of an interest crediting rate needs to be addressed separately in the manner described below. The general approach of the regulations is to change each specific feature that causes a crediting rate to be noncompliant, to the extent needed to make that feature compliant, while not changing other features of the existing interest crediting rate. Such changes in interest crediting rate would generally need to be applied prospectively.

- **Plan does not satisfy the timing rules for determining interest credits.** If a plan does not satisfy the timing rules for determining interest credits (e.g., the requirement that any lookback month or stability period comply with the lookback month and stability period rules under Treasury regulation Section 1.417(e)–1(d)(4)) the plan must be amended to correct the aspect of the plan’s interest crediting rate that does not satisfy those rules.

- **Plan credits impermissible fixed interest rate.** If a plan credits a fixed interest rate in excess of the maximum 6% rate permissible under the final regulations, the plan must be amended to reduce the fixed rate to 6%.

- **Plan adds excessive margin to Treasury rate.** If a plan credits a Treasury bond-based rate plus a margin that exceeds the maximum permissible margin under the final regulations, the plan must be amended to reduce the margin to the maximum permitted margin for the underlying rate used by the plan.

- **Plan credits bond-based rate with excessive minimum.** If a plan credits the greater of an otherwise permissible bond-based rate and a fixed rate that exceeds the highest permitted fixed minimum rate, the plan sponsor can either;
  - Eliminate the variable component of the rate and credit a fixed interest rate of 6%; or
Retain the variable component of the rate and reduce the fixed rate to the highest permitted fixed minimum rate.

- **Plan credits greater of two variable rates.** If a plan credits the greater of two otherwise permissible variable bond-based rates, the interest crediting rate must be capped at the third corporate bond segment rate.

- **Plan credits other impermissible bond-based rate.** If a plan credits an impermissible bond-based rate not otherwise described above, the plan must be amended to credit interest using a permissible rate with similar duration and quality characteristics if such a rate can be selected. If such a rate cannot be selected (e.g., because the interest crediting rate is based on bonds of a lower credit quality than those underlying the bond-based rates permissible under the final regulations) the interest crediting rate must be capped at the third corporate bond segment rate.

- **Plan credits noncompliant investment-based rate.** If a plan credits a noncompliant investment-based rate, the plan must be amended to credit a permissible investment-based rate with similar risk and return characteristics if possible – e.g., a plan that credits the return on the S&P 500 index rather than the return on a RIC that is designed to track the S&P 500 could be amended to credit the return on such a RIC. Otherwise, the plan must be amended to credit a permissible investment-based rate that is otherwise similar to the noncompliant rate (which would generally require the use of a rate that is less volatile than the noncompliant rate).

A plan may already have been amended to change its interest crediting rate under Section 1107 of PPA, which provided relief from the requirements of Code Section 411(d)(6) for an amendment made pursuant to PPA if the amendment was adopted by the last day of the first plan year beginning on or after January 1, 2009. If the interest crediting rate adopted under such an amendment is not permitted under the final regulations, the proposed regulations would permit a subsequent amendment to change the interest crediting rate to a rate that would be permissible under the final regulations.

*Aon Hewitt Comment:* The proposed regulations do not provide guidance on all situations in which an interest crediting rate may not comply with the final regulations. For example, the regulations request comments on potential transition approaches for plans crediting interest using a composite rate that is the greater of an investment-based rate and an impermissible annual (or more frequent) fixed or variable minimum rate. Further guidance may also be needed on how to apply the transition approaches described in the proposed regulations. For example, if a plan credits interest using a 12-month average of an otherwise permissible bond-based rate, it is unclear how the average should be changed to comply with the timing rules. Plan sponsors with such fact patterns may want to consider submitting comments on proposed transition approaches to the IRS.

**Participant Investment Direction and Target-Date Funds**

The 2014 final regulations do not explicitly allow for participant choice among investment-based interest crediting rates, and indicate that the Treasury and IRS are continuing to study the issues involved with such participant investment direction. The final regulations state that, in the event participant investment direction is ultimately not permitted and a plan provided for participant investment direction as of the date the final regulations were issued, it is anticipated that a plan which adopted such provisions before September 19, 2014 will be provided with relief from the anti-cutback provisions of Code Section 411(d)(6) so that it may be amended to change the interest crediting rate to a rate permissible under the final regulations.
In addition, while the 2014 final regulations do allow a plan to provide interest credits based on the rate of return on a RIC, the regulations do not explicitly allow the use of target-date funds, so that the interest credits a participant receives could potentially vary based on the participant’s age.

**Aon Hewitt Comment:** Treasury and IRS representatives have informally indicated that they have potential retirement policy concerns regarding participant investment direction in defined benefit plans, which may suggest that participant investment direction will ultimately not be permitted. As a result, plans that currently allow participant investment direction may want to consider whether to continue allowing such direction for future principal credits. Treasury and IRS representatives have also informally indicated that they believe the use of target date funds may prevent a plan from meeting the PPA age discrimination safe harbor, as the expected return (and volatility) of a target date fund for a given participant would generally be lower than the expected return (and volatility) for a similarly situated younger participant.

**Interest Credits Applied Toward Actuarial Increases After Normal Retirement Age**

Under the 2014 final regulations, effective for plan years beginning on or after January 1, 2016, a plan is not treated as providing an interest crediting rate in excess of a market rate of return, merely because the plan provides that the participant’s benefit, as of each annuity starting date after normal retirement age, is equal to the greater of the benefit determined using an interest crediting rate that does not exceed a market rate of return and the benefit that satisfies the non-forfeiture requirements of Code Section 411(a)(2).

**Aon Hewitt Comment:** The language of this exception suggests that interest credits can apply toward post-normal retirement age actuarial increases; provided the interest credits are not too low. However, the regulations provide no guidance on what interest rate would be considered too low for this purpose. Plan sponsors that have not previously issued suspension of benefits notices to participants working past normal retirement age in a statutory hybrid plan may want to consider issuing such notices to mitigate the risk that further actuarial adjustments may need to be provided. Of course, a participant who works beyond age 70½, whose required beginning date under the plan occurs after termination of employment, will need to receive an actuarial increase (possibly offset by additional accruals) for the period of employment beginning with the April 1 of the calendar year following the calendar year in which the participant attains age 70½ and ending on the date benefits satisfying the required minimum distribution rules under Code Section 401(a)(9) commence during which benefit payments were not made.

**Interest Rates and Interest Crediting Rates Upon Plan Termination**

The 2014 final regulations require that, if the interest crediting rate used to determine a participant’s accumulated benefit under a statutory hybrid plan has been a variable rate during the 5-year period ending on the plan termination date (including any case in which the interest crediting rate was not the same fixed rate during all such periods), the plan must provide that the interest crediting rate used to determine the participant’s accumulated benefit after the date of plan termination is the average of the interest crediting rates used under the plan during the 5-year period ending on the plan termination date. The average is determined as the arithmetic average of the rates used, with each rate adjusted to reflect the length of the interest crediting period and the average rate expressed as an annual rate. The rules in
the 2014 final regulations regarding interest crediting rates upon plan termination are effective for plan years beginning on or after January 1, 2016 (or an earlier date elected by the taxpayer).

The final regulations also require that the interest rate and mortality table (including tabular adjustment factors) used on and after plan termination for purposes of determining benefits payable in the form of an annuity commencing at or after normal retirement age must be the interest rate and mortality table specified under the plan for that purpose as of the termination date. If the interest rate has been a variable rate during the 5-year period ending on the plan termination date (including any case in which the interest rate was not the same fixed rate during such 5-year period), then the interest rate used on and after plan termination is calculated using the same process described above for determining the participant’s accumulated benefit after the date of plan termination.

In the case of a plan using an interest crediting rate equal to, or that can never exceed, one of the segment rates, bond rates, or cost-of-living indices listed above, or a fixed interest rate that has not been the same rate during the entire 5-year period ending on the plan termination date, the actual interest rate that applied under the plan for an interest crediting period is used for purposes of determining the average interest crediting rate. If applicable, the floor described in the section Fixed 4% or 5% Floor Applied to Bond-Based Rates is taken into account. For purposes of determining the average interest crediting rate, the rate that applied for the interest crediting period takes into account minimums, maximums, and other reductions that applied in the period, other than cumulative floors described in the section Fixed 3% Floor Applied to Investment-Based or Bond-Based Rates.

In the case of a plan using an annuity contract rate, the return on plan assets, or the return on a RIC, the interest crediting rate that applied for an interest crediting period for purposes of determining the average interest crediting rate is deemed to be equal to the second corporate bond segment rate (described above) for the last calendar month ending before the beginning of the interest crediting period, as adjusted to account for any minimums or maximums that applied in the period (other than cumulative floors described in the section Fixed 3% Floor Applied to Investment-Based or Bond-Based Rates), but without regard to other reductions that applied in the period. This represents a change from the 2010 proposed regulations, which would have required the use of the third corporate bond segment rate for this purpose rather than the second segment rate.

**Changes to Interest Crediting Rate Prior to Plan Termination**

If a participant’s accumulated benefit at the end of the last interest crediting period prior to plan termination is based on a Code Section 411(d)(6) protected benefit resulting from a prior amendment to change the plan’s interest crediting rate, then the pre-amendment interest crediting rate is treated as having applied for each interest crediting period after the date of the interest crediting rate change for purposes of determining the average interest crediting rate.

**Blended Rates Upon Plan Termination**

If a plan determines the interest credit in any interest crediting period by applying different rates to different predetermined portions of the accumulated benefit, then the interest crediting rate that applied for the interest crediting period for purposes of determining the average interest crediting rate is the weighted average of the relevant interest rates that apply to each portion of the accumulated benefit.
Participants With Less Than Five Years of Interest Credits Upon Plan Termination

For purposes of determining an individual’s average interest crediting rate, if an individual was not eligible to receive interest credits under the terms of the plan during any interest crediting period within the 5-year period ending on the plan termination date (e.g., the individual was not a participant or beneficiary in the relevant interest crediting period), the individual is treated as having received interest credits in that period using the interest crediting rate that applied under the terms of the plan to a similarly situated participant or beneficiary who was eligible to receive interest credits in that period. However, if the individual was not eligible to receive any interest credits under the terms of the plan during the entire 5-year period ending on the plan termination date, then the rules to determine the average interest crediting rate used to determine the individual’s benefit after plan termination do not apply.

Whipsaw Relief

PPA provided that a statutory hybrid plan that determines any portion of a participant’s benefits under a lump-sum based benefit formula does not fail to satisfy the non-forfeiture requirements and lump-sum present value requirements under Code Sections 411(a)(2), 411(a)(11), 411(c), and 417(e) merely because the present value of the participant’s benefits is equal to the then-current balance of the participant’s cash balance account or value of the participant’s accumulated percentage of final average compensation. Thus, PPA indicated that a participant’s cash balance account (or accumulated percentage of final average compensation) need not necessarily be projected forward with interest credits, converted to an annuity at normal retirement age, and discounted back using Code Section 417(e) mortality and interest factors; i.e., a whipsaw calculation is not required if the plan provides for payment of the participant’s cash balance account (or accumulated percentage of final average compensation) as the lump sum.

Like the 2010 proposed regulations, the 2014 final regulations do not extend this relief to a benefit formula that is not a lump-sum based benefit formula but has an effect similar to a lump-sum based benefit formula (defined under the section Three-Year Minimum Vesting Requirement).

As a reminder, the whipsaw relief under Code Section 411(a)(13)(A) is relief only with respect to the requirements of Code Section 411(c), the non-forfeiture requirements of Code Section 411(a)(2), and the present value requirements of Code Sections 411(a)(11) and 417(e), with respect to accrued benefits derived from employer contributions.

Lump-Sum Based Benefit Formula

A lump-sum based benefit formula is a benefit formula used to determine all or any part of a participant’s accumulated benefit under a defined benefit plan where the benefit is expressed as the current balance of a hypothetical account maintained for the participant (a cash balance formula) or as the current value of an accumulated percentage of the participant’s final average compensation (a pension equity formula). A participant’s accumulated benefit as of any date means the participant’s benefit, as expressed under the terms of the plan, accrued to that date. Whether a benefit formula is a lump-sum based benefit formula is determined based on how the accumulated benefit of a participant is expressed under the terms of the plan, and does not depend on whether the plan provides a lump-sum form of benefit payment or defines a participant’s accrued benefit as an annuity beginning at normal retirement age that is actuarially equivalent to the accumulated benefit.
A benefit properly attributable to after-tax employee contributions, rollover contributions, and other similar employee contributions (such as repayments of distributions and employee pickup contributions) is disregarded for purposes of the definition of a lump-sum based benefit formula. However, the benefit is not properly attributable to contributions if the contributions are credited with interest at a rate exceeding a reasonable rate of interest or if the conversion factors used to calculate the benefit are not actuarially reasonable.

The 2014 final regulations clarify that only a cash balance or pension equity benefit formula can be a lump-sum based benefit formula and further clarify that a formula, which expresses the accumulated benefit as a single-sum dollar amount at normal retirement age, is not a lump-sum based benefit formula. The 2014 final regulations confirm that a lump-sum based benefit formula is not required to provide interest credits, but must express the accumulated benefit as a current single-sum dollar amount. These two clarifications and this confirmation are effective for plan years beginning on or after January 1, 2011.

For plan years beginning on or after January 1, 2016 (or an earlier date as elected by the taxpayer), the 2014 final regulations expand the definition of pension equity formula to include a benefit formula that is expressed as a current single-sum dollar amount equal to a percentage of the participant’s highest average compensation (with a permitted lookback period for determining highest average compensation, such as the highest five out of the last 10 years).

For plan years that begin on or after January 1, 2016, the 2014 final regulations require that, for a benefit formula to constitute a lump-sum based benefit formula, a distribution of the benefits under that formula in the form of a single-sum payment must equal the accumulated benefit under that formula. Thus, if a cash balance or pension equity plan pays the greater of: (1) the accumulated benefit under the cash balance or pension equity formula, whichever applies; or (2) the lump-sum value of the accrued benefit under the plan, determined using Code Section 417(e) factors (e.g., if the plan provides for whipsaw), the formula does not constitute a lump-sum based formula for plan years beginning after December 31, 2015. One exception to this requirement applies to the extent the single-sum payment is greater than the accumulated benefit under the formula to satisfy the anti-cutback requirements of Code Section 411(d)(6) in complying with the 2014 final regulations. Thus, a cash balance or pension equity plan applying whipsaw for benefits accrued in plan years beginning after December 31, 2015 does not have a lump-sum based formula because whipsaw is not required to satisfy Code Section 411(d)(6).

**Aon Hewitt Comment:** Sponsors of cash balance and pension equity plans that have continued to perform whipsaw calculations will want to reexamine whether they want to continue whipsaw calculations into plan years beginning after December 31, 2015 and the ramifications of doing so, such as losing the applicability of the age discrimination safe harbor to their cash balance or pension equity formulas. Such sponsors should begin considering whether and how to amend their plans to eliminate whipsaw for plan years beginning after December 31, 2015, taking into account how Code Section 411(d)(6) may apply.

**Regulatory Requirements for Whipsaw Relief**

If a formula is not a lump-sum based benefit formula, the plan must satisfy the rules that would otherwise apply in the absence of whipsaw relief, such as applying the minimum present value requirements of Code Section 417(e) to the portion of the accrued benefit determined under that formula in order to determine the amount of a single-sum distribution option. Under the 2014 final regulations, only a cash balance or pension equity benefit formula can be a lump-sum based benefit formula, but a cash balance
or pension equity formula that expresses the accumulated benefit as a single-sum dollar amount at normal retirement age is not a lump-sum based benefit formula (and, therefore, not eligible for the whipsaw relief of Code Section 411(a)(13)(A)).

**Whipsaw Relief If Accumulated Benefit Actuarily Equivalent at Normal Retirement Age or Annuity Starting Date**

Under the 2014 final regulations, for plan years beginning on or after January 1, 2016, a cash balance formula or pension equity formula is treated as a lump-sum based benefit formula (to which the whipsaw relief of Code Section 411(a)(13)(A) applies), only if the portion of the participant’s accrued benefit that is determined under that formula and the then-current balance of the hypothetical account or the then-current value of the accumulated percentage of the participant’s final average compensation (whichever formula is applicable) is actuarially equivalent (using reasonable actuarial assumptions) to the cash balance account or pension equity accumulation either upon attainment of normal retirement age or at the annuity starting date for a distribution with respect to that portion.

**Actuarial Increase for Accumulated Benefit After Normal Retirement Age**

The 2014 final regulations further provide that, effective for plan years beginning on or after January 1, 2016 (or an earlier date elected by the taxpayer), a plan with a cash balance or pension equity formula violates the non-forfeiture requirements of the Code if the cash balance account or pension equity accumulation is not increased sufficiently to satisfy the requirements of Code Section 411(a)(2) for distributions commencing after normal retirement age, unless the plan suspends benefits in accordance with Code Section 411(a)(3)(B).

*Aon Hewitt Comment:* This suggests that interest credits can apply toward post-normal retirement age actuarial increases; provided the interest credits are not too low. Also see the Aon Hewitt Comment under the section *Interest Credits Applied Toward Actuarial Increases After Normal Retirement Age*.

**Certain Reductions in Accumulated Benefit Permitted**

Under the 2014 final regulations, for plan years beginning on or after January 1, 2016, certain reductions in the accumulated benefit are permitted that do not affect the whipsaw relief of Code Section 411(a)(13)(A) to pay a lump-sum based benefit in the form of a single-sum payment equal to the accumulated benefit. As in the 2010 proposed regulations, such permitted exceptions include reductions in the accumulated benefit as a result of: benefit payments; qualified domestic relations orders; forfeitures permitted under Code Section 411(a), such as charges for a qualified preretirement survivor annuity; amendments permitted under Code Section 411(d)(6) that would reduce the accrued benefit; or adjustments to a hypothetical account balance due to permitted negative interest crediting rates. However, unlike the 2010 proposed regulations, the 2014 final regulations do not set forth explicit rules as to what constitutes “benefit payments.” The regulations also contain a provision allowing the Commissioner to add to the list of permitted reductions through guidance of general applicability.

However, in response to questions on the 2010 proposed regulations as to whether the restrictions on reductions in the accumulated benefit, as applied to pension equity formulas, were also intended to disallow reductions that result from decreases in the participant’s final average compensation, the 2014 final regulations clarify that a reduction in the pension equity accumulation is permitted to the extent that it...
results from a decrease in the participant’s final average compensation or from an increase in the integration level (in the case of a formula that is integrated with Social Security).

**Aon Hewitt Comment:** It seems that this exception, and any of the other exceptions for reductions in the accumulated benefit, do not carry over to the accrued benefit under the plan except as may otherwise be permitted under the Code with respect to accrued benefits (as defined under Code Section 411(a)(7) rather than Code Section 411(b)(5)(G)). For example, it appears that the whipsaw relief afforded to reductions in a pension equity accumulated benefit resulting from decreases in a participant’s final average compensation has no bearing on whether the accrued benefit satisfies the accrual rule requirements of Code Section 411(b)(1), because the whipsaw relief under Code Section 411(a)(13)(A) is relief only with respect to the requirements of Code Section 411(c), the non-forfeiture requirements of Code Section 411(a)(2), and the present value requirements of Code Sections 411(a)(11) and 417(e), with respect to accrued benefits derived from employer contributions. Accordingly, it also appears that the whipsaw relief does not provide any relief with respect to the normal retirement benefit requirements of Code Section 411(a)(9), including the “highest early rule” of Treasury regulation Section 1.411(a)-7(c).

**Application of Whipsaw Relief to Optional Forms, Including Subsidized Optional Forms**

The 2014 final regulations provide that, effective for plan years beginning on or after January 1, 2016, the relief of Code Section 411(a)(13)(A) also applies to a subsidized optional form 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. In particular, with respect to benefits under a lump-sum based benefit formula, if an optional form of benefit is payable in an amount that is greater than the actuarial equivalent, determined using reasonable actuarial assumptions, of the cash balance account or pension equity accumulation, then the plan satisfies the requirements of Code Sections 411(a)(2), 411(a)(11), 411(c), and 417(e) with respect to the amount of that optional form of benefit. However, if an optional form of benefit is not at least the actuarial equivalent (using reasonable actuarial assumptions) of the cash balance account or pension equity accumulation, then payment of that optional form of benefit must satisfy the rules applicable to payment of the accrued benefit without regard to the whipsaw relief of Code Section 411(a)(13)(A) and the regulations, including the requirements of Code Section 411(a)(2) and, for optional forms subject to the minimum present value requirements of Code Section 417(e)(2), those minimum present value requirements. Note that the age discrimination safe harbor rules limit the amount of the subsidized early retirement benefit so that it does not exceed the benefit available to a similarly situated, older participant who is currently at normal retirement age.

**Proportional Application of Whipsaw Relief to Partial Payments of Accumulated Benefit**

The 2014 final regulations provide that, effective for plan years beginning on or after January 1, 2016, the relief from whipsaw calculations applies on a proportionate basis to a payment of a portion of the benefit under a lump-sum based benefit formula, such as a payment of a specified dollar amount or a specified percentage of the accumulated benefit. For example, if a cash balance plan distributes 40% of the participant’s then-current hypothetical account balance in a single payment, the plan is treated as satisfying the requirements of Code Section 411(a) and the minimum present value rules of Code Section 417(e) with respect to 40% of the participant’s then-current accrued benefit.
Application of Whipsaw Relief to Greater-of, Sum-of, and Lesser-of Formulas

The 2014 final regulations provide that the whipsaw relief applies only to the portion of the participant’s benefit that is determined under a lump-sum based benefit formula and does not apply to any portion of the participant’s benefit that is determined under a formula that is not a lump-sum based benefit formula. Effective for plan years beginning on or after January 1, 2016, the 2014 final regulations provide rules for the application of whipsaw relief to greater-of and sum-of formulas, similar to the 2010 proposed regulations, but also add rules for lesser-of formulas.

Greater-of Formulas—If a participant’s accrued benefit under the plan is the greater of the benefit under a lump-sum based benefit formula and the benefit under a formula that is not a lump-sum based benefit formula, a single-sum payment of the participant’s entire benefit must be no less than the greater of the then-current accumulated benefit under the lump-sum based benefit formula and the present value of the benefit under the other formula determined in accordance with Code Section 417(e). The 2014 final regulations provide an example in which, if the other formula provides a benefit equal to a pro-rata portion of a normal retirement benefit determined by projecting the hypothetical account balance (including future principal and interest credits) to normal retirement age, a single-sum payment of the participant’s entire benefit must be no less than the greater of the then-current balance of the hypothetical account and the present value, determined in accordance with Code Section 417(e), of the pro-rata benefit determined by projecting the hypothetical account balance to normal retirement age.

Aon Hewitt Comment: The requirement regarding greater-of benefits where one of the benefits is determined by projecting a hypothetical account balance may be directed at plans where a project-and-prorate minimum benefit is used to ensure compliance with the fractional accrual rule. For example, a plan could provide that a participant’s benefit is the greater of the current cash balance account and a projected-and-prorated cash balance account in order to comply with the fractional accrual rule. In such a situation, the present value of the projected-and-prorated benefit would need to be determined using Code Section 417(e) rules in comparing to the current cash balance account.

Sum-of Formulas—If a participant’s accrued benefit under the plan is the sum of: (1) the benefit under a lump-sum based benefit formula; and (2) the benefit under another formula that is not a lump-sum based benefit formula; then a single-sum payment of the participant’s entire benefit must be no less than the sum of the then-current accumulated benefit under the lump-sum based benefit formula and the present value, determined in accordance with Code Section 417(e), of the pro-rata benefit determined by projecting the hypothetical account balance to normal retirement age.

Aon Hewitt Comment: The 2014 final regulations provide an example, in which the accrued benefit under a plan is determined as the sum of the accrued benefit attributable to the balance of a hypothetical account and the accrued benefit equal to the excess of the benefit under another formula over the benefit under the hypothetical account formula. The example concludes that, in such a case, a single-sum payment of the participant’s entire benefit must be no less than the sum of the then-current balance of the hypothetical account and the present value, determined in accordance with Code Section 417(e), of the excess of the benefit under the other formula over the benefit under the hypothetical account formula. It is not entirely clear at which plan designs this example is directed. It also appears that by merely altering certain designs this example could yield a different result than the greater-of formula rule above.

Lesser-of Formulas—If a participant’s accrued benefit equals the lesser of the benefit under a lump-sum based benefit formula and the benefit under another formula that is not a lump-sum based benefit formula, a single-sum payment of the participant’s entire benefit must be no less than the lesser of the
then-current accumulated benefit under the lump-sum based benefit formula and the present value, determined in accordance with Code Section 417(e), of the benefit under the other formula. If the formula that is not a lump-sum based benefit formula is the maximum annual benefit described in Code Section 415(b), then the single-sum payment of the participant’s entire benefit must not exceed the then-current accumulated benefit under the lump-sum based benefit formula. The 2014 final regulations provide an example in which, if the benefit under a plan is determined as the benefit attributable to the balance of a hypothetical account, but no greater than a benefit payable at normal retirement age in the form of a straight life annuity of $100,000 per year, a single-sum payment of the participant’s entire benefit must be no less than the lesser of the then-current balance of the hypothetical account and the present value, determined in accordance with Code Section 417(e), of a benefit payable at normal retirement age in the form of a straight life annuity of $100,000 per year.

Three-Year Minimum Vesting Requirement

If any portion of a participant’s accrued benefit under a defined benefit plan is determined under a statutory hybrid benefit formula, the plan must provide that the participant’s entire accrued benefit is fully vested if the participant has three or more years of service. This vesting requirement applies to participants who have an hour of service on or after the statutory effective date of the three-year vesting rules that applies to the plan. This rule applies even if either: (1) a portion of the accrued benefit is determined under a formula that is not a statutory hybrid benefit formula; or (2) the larger benefit under a greater-of benefit formula including a statutory hybrid benefit formula is a formula that is not a statutory hybrid benefit formula.

The three-year vesting rule does not apply to a participant whose benefit is not determined under a statutory hybrid benefit formula, even if other participants in the same plan are subject to the rule. Further, as illustrated by an example in the regulations, a participant’s accrued benefit based a formula that is not a statutory hybrid benefit formula is not subject to the three-year vesting requirement if it is not part of the same plan containing the statutory hybrid benefit formula, even if the accrued benefit under the plan containing the statutory hybrid benefit formula offsets all or a portion of the accrued benefit under the other plan.

A statutory hybrid benefit formula includes both a benefit formula that is a lump-sum based benefit formula and a formula that is not a lump-sum based benefit formula but has an effect similar to a lump-sum based benefit formula. Unlike the relief from whipsaw, the three-year minimum vesting requirement applies to a formula that is not a lump-sum based benefit formula but has an effect similar to a lump-sum based benefit formula, as well as to a lump-sum based benefit formula.

Formula With an Effect Similar to a Lump-Sum Based Benefit Formula

A defined benefit plan formula that is not a lump-sum based benefit formula has an effect similar to a lump-sum based benefit formula, if the formula expresses a participant’s accumulated benefit as a benefit that includes the right to adjustments (including a formula that provides for indexed benefits, as defined under the regulations) for a future period and the total dollar amount of the adjustments is reasonably expected to be smaller for the participant than for a similarly situated, younger individual who is, or could be, a participant in the plan. For plan years beginning on or after January 1, 2016, the right to adjustments for a future period means the right to any changes in the dollar amount of benefits over time, regardless of whether those adjustments are denominated as interest credits. An increase in the dollar amount of benefits over time, such as an actuarial increase or the unwinding of an actuarial reduction for
early retirement, is treated as such an adjustment. For example, an indexed career average pay plan would be considered as having an effect similar to a lump-sum based benefit formula.

A pattern of repeated amendments providing for such adjustments can result in a formula with an effect similar to a lump-sum based benefit formula. For example, a non-indexed career average pay plan could potentially be considered as having an effect similar to a lump-sum based benefit formula if the plan is regularly amended to provide participants with career average earnings updates based on the change in CPI over a specified period.

The following are not treated as adjustments creating a benefit formula with an effect similar to a lump-sum based benefit formula:

**Post-Retirement Benefit Adjustments**—Adjustments in the amount payable after a participant’s annuity starting date, such as cost-of-living increases, are disregarded.

**Variable Annuity Benefit Formulas**—The 2014 final regulations broaden the definition of a variable annuity benefit formula to include any defined benefit plan formula that periodically adjusts the amount payable by reference to the difference between a rate of return (not limited to the rate of return on plan assets or specified market indices) and a specified assumed interest rate. However, only a variable annuity benefit formula that adjusts benefits by reference to the difference between a rate of return on plan assets (or specified market indices) and a specified assumed interest rate of 5% or higher, is treated as being reasonably expected to provide a smaller total dollar amount of future adjustments for the participant than for any similarly situated, younger individual who is or could be a participant in the plan, and thus does not have an effect similar to a lump-sum based benefit formula. For plan years beginning on or after January 1, 2016, or any earlier date as elected by the taxpayer, the rate of return on plan assets (or specified market index) by reference to which the benefit formula adjusts must be either: the actual rate of return on plan assets or a subset of plan assets, the rate of return on the market index specified under an annuity contract for an employee issued by an insurance company licensed under state law, or the rate of return on a RIC. Such a variable annuity benefit formula that does not have an effect similar to a lump-sum based benefit formula is not subject to the three-year vesting requirement.

A variable annuity benefit formula that does not fall within the exception is, nevertheless, not a statutory hybrid benefit formula (i.e., does not have an effect similar to a lump-sum based benefit formula), if the specified assumed interest rate is high enough in relation to the reasonable expectation of the rate of return to which it is compared, such that the adjustments under the formula are not reasonably expected to be positive. However, if the specified assumed interest rate is too high relative to the reasonable expectation of the rate of return to which it is compared, a variable annuity benefit formula risks violating the requirement under Code Section 411(b)(1)(G) that the accrued benefit not decrease on account of an increase in age or service.

**Employee Contributions**—A benefit properly attributable to after-tax employee contributions, rollover contributions, and other similar employee contributions (such as repayments of distributions and employee pickup contributions) is disregarded for purposes of the definition of a lump-sum based benefit formula. However, the benefit is not properly attributable to contributions if the contributions are credited with interest at a rate exceeding a reasonable rate of interest or if the conversion factors used to calculate the benefit are not actuarially reasonable.
Actuarial Reductions for Early Commencement Under a Traditional Formula—Provided that the benefit payable at normal retirement age to a participant cannot be less than the benefit payable at normal retirement age to any similarly situated, younger individual, who is or could be a participant in the plan, a defined benefit formula is not treated as having an effect similar to a lump-sum based benefit formula with respect to the participant merely because the formula provides for a reduction in the benefit payable at early retirement due to early commencement. This exception has the effect of excluding a traditional defined benefit formula (and other formulas that merely provide for actuarial reduction for early commencement) from treatment as a formula with an effect similar to a lump-sum based benefit formula, despite the treatment of actuarial increases in benefits over time as adjustments under the definition of a formula that has an effect similar to a lump-sum based benefit formula.

Age Discrimination Safe Harbor

The age discrimination safe harbor provides that a plan is not treated as failing to satisfy the requirements of Code Section 411(b)(1)(H)(i) with respect to an individual who is or could be a participant if, as of any date, the accumulated benefit of the individual would not be less than the accumulated benefit of any similarly situated, younger individual who is or could be a participant. This safe harbor also applies to the corresponding provisions of ERISA and ADEA. A plan is not treated as failing to meet these requirements merely because the plan provides for disparity in contributions or benefits as permitted under Code Section 401(l) or to the extent offsets are allowable under the Code, ERISA, or ADEA.

Similarly Situated

An individual is similarly situated to another individual if the individual is identical to the other individual in every respect relevant to determining a participant’s benefit under the plan (including period of service, compensation, position, date of hire, work history, and any other respect) except for age. Any characteristic relevant for determining benefits under the plan based directly or indirectly on age is disregarded. Any subsidized portion of any early retirement benefit included in a participant’s accumulated benefit is disregarded for purposes of the age discrimination safe harbor. An individual is not similarly situated to a participant if a different benefit formula applies to the individual and the application of the different formula is not based directly or indirectly on age.

The 2014 final regulations revise and clarify the prior regulations regarding what constitutes a subsidized portion of an early retirement benefit for purposes of the age discrimination safe harbor. To facilitate phased retirement, the requirement that a subsidized portion of an early retirement benefit must be contingent on severance from employment has been removed. An early retirement benefit includes a subsidized portion only if the benefit provides a greater actuarial present value on account of commencement before normal retirement age. However, for plan years beginning after December 31, 2015, any excess of:

- the annual benefit payable before normal retirement age for a participant; over
- the corresponding form of benefit for any similarly situated, older individual, who is or could be a participant and is currently at or before normal retirement age;

is not part of the subsidized portion of an early retirement benefit and such excess is not disregarded for purposes of the age discrimination safe harbor.

Social security leveling options and social security supplements are disregarded when determining whether such an excess exists. If such an excess exists, the age discrimination safe harbor typically will
not be satisfied. Further, a plan is not treated under the age discrimination safe harbor as providing a greater annual benefit to a participant merely because the reduction in the amount of an annuity to reflect a survivor benefit, based on actuarial equivalence using reasonable actuarial assumptions, is smaller for the participant than for a similarly situated, older individual who is or could be a participant.

Safe-Harbor Formula Measure

The 2010 final regulations introduced the concept of a safe-harbor formula measure and generally required that the age discrimination safe harbor is available with respect to an individual who is or could be a participant only if:

- The individual's accumulated benefit under the plan is expressed in terms of just one safe-harbor formula measure; and
- No similarly situated, younger individual who is or could be a participant has an accumulated benefit that is expressed in terms of any measure other than that same safe-harbor formula measure (the similarly situated test).

The three safe-harbor measures correspond to the three definitions of accumulated benefit:

- The annuity payable at normal retirement age (or current age, if later) if the accumulated benefit of the participant under the terms of the plan is an annuity payable at normal retirement age (or current age, if later).
- The current balance of a hypothetical account maintained for the participant if the accumulated benefit of the participant under the terms of the plan is a balance of a hypothetical account.
- The current value of an accumulated percentage of the participant's final average compensation if the accumulated benefit of the participant under the terms of the plan is an accumulated percentage of final average compensation.

For plan years beginning on or after January 1, 2016, the 2014 final regulations provide that a benefit measure for a cash balance or pension equity formula is a safe-harbor formula measure only if the cash balance or pension equity formula satisfies the requirements to be a lump-sum based benefit formula.

**Aon Hewitt Comment:** It appears that, for plan years beginning on or after January 1, 2016, a cash balance or pension equity formula that does not satisfy the requirements of the 2014 final regulations to be a lump-sum based benefit formula cannot use the age discrimination safe harbor. Thus, a cash balance or pension equity plan that provides for whipsaw calculations, unless amended to eliminate whipsaw calculations for plan years beginning on or after January 1, 2016, will not be able to satisfy the age discrimination safe harbor and, therefore, will almost certainly be age discriminatory. It also appears that any benefit formula that has an effect similar to a lump-sum based benefit formula and is not a lump-sum based benefit formula cannot satisfy the age discrimination safe harbor, if the accumulated benefit of the participant under the terms of the plan is not an annuity payable at normal retirement age (or current age, if later).

Exceptions to the Safe-Harbor Formula Measure Requirement

Like the 2010 final regulations, the 2014 final regulations provide three important exceptions to the safe-harbor formula measure requirement described above for choice-of benefit formulas, greater-of benefit formulas, and sum-of benefit formulas, but also add a fourth exception for lesser-of benefit formulas. The addition of this lesser-of comparison is to clarify that certain limitations on benefits, such as
those required to comply with Code Section 415, would not necessarily keep a plan from satisfying the age discrimination safe harbor.

**Lesser-of Benefit Formulas**

If a plan provides a participant’s accumulated benefit expressed as a single safe-harbor formula measure and no accumulated benefit of a similarly situated, younger individual, who is or could be a participant, is expressed other than as either:

- a benefit that is determined under the same safe-harbor formula measure; or
- the lesser of benefits under two or more benefit formulas, at least one of which is expressed in terms of the same safe-harbor formula measure;

the plan satisfies the age discrimination safe harbor with respect to the participant only if the plan satisfies the age discrimination safe harbor for benefits determined in terms of the same safe-harbor formula measure.

Similarly, if a plan provides a participant’s accumulated benefit expressed as the lesser of benefits under two or more benefit formulas, each of which is determined in terms of a different safe-harbor formula measure, the plan satisfies the age discrimination safe harbor with respect to the participant only if:

- The plan satisfies the age discrimination safe harbor separately for benefits determined in terms of each safe-harbor formula measure; and
- No accumulated benefit of a similarly situated, younger individual, who is or could be a participant, is expressed other than as the lesser of benefits under two or more benefit formulas, expressed in terms of all of those same safe-harbor formula measures (and any other additional formula measures).

**Choice-of Benefit Formulas**

If a plan provides a participant a choice between benefits determined in terms of two or more different safe-harbor formula measures, the plan satisfies the age discrimination safe harbor with respect to that participant, provided the plan satisfies the age discrimination safe harbor for each safe-harbor formula measure and no accumulated benefit of a similarly situated, younger individual, who is or could be a participant, is expressed other than as:

- The choice of benefits determined under two or more benefit formulas, each of which is expressed in terms of one of those same safe-harbor formula measures as is used for the participant’s (not the similarly situated, younger individual’s) choice-of benefit;
- A benefit that is determined in terms of only one of those same safe-harbor formula measures; or
- The lesser of benefits under two or more benefit formulas, at least one of which is expressed in terms of one of those same safe-harbor formula measures.

This exception applies to all situations where choice is offered and is not limited to a choice offered only to participants who had attained a specified age by a specific date.

**Greater-of Benefit Formulas**

If a plan provides a participant’s accumulated benefit expressed as the greater of benefits under two or more benefit formulas, each of which is determined in terms of a different safe-harbor formula measure,
the plan satisfies the age discrimination safe harbor with respect to the participant, provided that the plan satisfies the age discrimination safe harbor separately for benefits determined in terms of each safe-harbor formula measure and no accumulated benefit of a similarly situated, younger individual who is or could be a participant is expressed other than as:

- The greater of benefits determined under two or more benefit formulas, each of which is expressed in terms of one of those same safe-harbor formula measures as is used for the participant’s greater-of benefit;
- The choice of benefits determined under two or more benefit formulas, each of which is expressed in terms of one of those same safe-harbor formula measures;
- A benefit that is determined in terms of only one of those same safe-harbor formula measures; or
- The lesser of benefits under two or more benefit formulas, at least one of which is expressed in terms of one of those same safe-harbor formula measures.

**Aon Hewitt Comment:** The similarly situated test may still be cause for some confusion in its application. For example, consider two individuals covered by the same plan who are identical except for a 30-year age difference. As of a specified date, the plan provides those participants age 55 and older with the greater of the existing final average pay benefit formula and a new cash balance formula. All younger participants as of that date are eligible only for the new cash balance formula. Assume all plan conversion requirements are met and both formulas on their own would satisfy the similarly situated test. On the conversion date, individual A is 55 years old and individual B is 25 years old. Individuals A and B each have 5 years of service on the conversion date and each continues employment for 10 years thereafter. Each commences benefits at normal retirement age of 65. Simply due to interest credits, individual B will at some point have a larger cash balance accumulated benefit than individual A. If these two individuals are treated as similarly situated, then the plan would fail the age discrimination safe harbor and, based simply on the time value of money, no cash balance benefit formula could satisfy the age discrimination safe harbor. However, the only reasonable way to view this situation is that the individuals are not similarly situated because their actual dates of benefit commencement differ. Even though both individuals commence benefits at normal retirement age, normal retirement age at 65 is an age-based distinction that results in different benefit commencement dates for the two individuals, so the individuals are not similarly situated.

**Sum-of Benefit Formulas**

If a plan provides a participant’s accumulated benefit expressed as the sum of benefits determined in terms of two or more benefit formulas, each of which is expressed in terms of a different safe-harbor formula measure, the plan satisfies the age discrimination safe harbor with respect to the participant, provided that the plan satisfies the age discrimination safe harbor separately for benefits determined in terms of each safe-harbor formula measure and no accumulated benefit of a similarly situated, younger individual who is or could be a participant is expressed other than as:

- The sum of benefits under two or more benefit formulas, each of which is expressed in terms of one of those same safe-harbor formula measures as is used for the participant’s sum-of benefit;
- The greater of benefits under two or more benefit formulas, each of which is expressed in terms of any one of those same safe-harbor formula measures;
- The choice of benefits under two or more benefit formulas, each of which is expressed in terms of any one of those same safe-harbor formula measures;
A benefit that is determined in terms of only one of those same safe-harbor formula measures; or

The lesser-of benefits under two or more benefit formulas, at least one of which is expressed in terms of one of those same safe-harbor formula measures.

**Aon Hewitt Comment:** It is important to note that, if a plan permits older participants to continue only in the existing plan benefit formula and covers others under a statutory hybrid plan formula, the plan will not be able to satisfy the similarly situated test to be deemed not age discriminatory. For example, if a final average pay plan converts to cash balance and provides that all participants at least age 55 at the time of the conversion remain under the final average pay formula, the exceptions above will not apply, so the plan cannot satisfy the similarly situated test with respect to those participants at least age 55 at the time of the conversion. For the exceptions to apply, the participants who are at least age 55 at the time of the conversion must either be provided a choice between the two formulas or the greater of the two formulas. Alternatively, they could be provided the sum of the two formulas, but it is unlikely many plan sponsors would choose to provide double benefits for the same period of service.

**Indexed Benefits**

A defined benefit plan is not treated as failing to meet the requirements of Code Section 411(b)(1)(H) and the corresponding sections of ERISA and ADEA with respect to a participant solely because a benefit formula (other than a lump-sum based benefit formula) under the plan provides for the periodic adjustment of the participant’s accrued benefit by means of a recognized index or methodology. For plan years that begin on or after January 1, 2016, or an earlier date as elected by the taxpayer, any subsidized portion of any early retirement benefit (as defined under the section Similarly Situated) under such a plan is disregarded in determining whether the plan meets the requirements of Code Section 411(b)(1)(H). If the plan has an effect similar to a lump-sum based benefit formula, the plan satisfies the qualification requirements otherwise applicable to a statutory hybrid plan, including the three-year vesting and preservation of capital requirements (described above) and the plan conversion amendment requirements (described below). A rate that does not exceed a market rate of return is deemed to be a recognized index or methodology.

The plan must satisfy the similarly situated test such that the aggregate adjustments made to a participant’s accrued benefit under the plan (determined as a percentage of the unadjusted accrued benefit) in a period would not be less than the aggregate adjustments for any similarly situated, younger participant. The similarly situated test for such plan requires a comparison, for each period, of the aggregate adjustments for each individual who is or could be a participant in the plan for the period with the aggregate adjustments of each other similarly situated, younger individual who is or could be a participant in the plan for the period.

**Conversions to Statutory Hybrid Plans**

A plan that converts to a statutory hybrid plan is treated as failing to comply with the age discrimination prohibitions of the Code, ERISA, and ADEA unless the conversion amendment satisfies specified criteria. The criteria generally apply on a participant by participant basis.
Protections Against Wearaway

A conversion amendment must generally provide that, in the case of an individual who was a participant in the plan immediately before the conversion amendment adoption date, the participant’s benefit at any subsequent annuity starting date is not less than the sum of (A) and (B), where:

- (A) is the participant’s Code Section 411(d)(6) protected benefit with respect to service before the conversion amendment effective date, determined under the terms of the plan as in effect immediately before the conversion amendment effective date; and
- (B) is the participant’s Code Section 411(d)(6) protected benefit with respect to service on and after the conversion amendment effective date, determined under the terms of the plan as in effect after the conversion amendment effective date.

The (A) and (B) components described above must each be determined in the same manner as if they were provided under separate plans independent of one another (e.g., without any benefit offsets), and, except to the extent permitted otherwise permitted under Code Section 411(d)(6) anti-cutback rules (or other applicable law), each optional form of payment provided under the terms of the plan with respect to a participant’s protected benefit as in effect before the conversion amendment must be available thereafter to the extent of the participant’s benefits for service prior to the effective date of the conversion amendment.

Conversion Amendment

A conversion amendment is an amendment that, with respect to a participant:

- Reduces or eliminates the benefits that, but for the amendment, the participant would have accrued after the effective date of the amendment under a benefit formula that is not a statutory hybrid benefit formula (and under which the participant was accruing benefits prior to the amendment); and
- After the effective date of the amendment, all or a portion of the participant’s benefit accruals under the plan are determined under a statutory hybrid benefit formula.

The conversion amendment effective date with respect to an individual participant is the date as of which the reduction of the participant’s future accruals described in the first bullet above occurs, and cannot be earlier than the conversion amendment adoption date. This means that, in a conversion where participants accrue benefits under both a hybrid formula and a prior traditional formula during a transition period, the “A+B” protection described above applies at the end of the transition period rather than the beginning of the transition period. The preamble to the 2010 final regulations states that suggestions for the conversion amendment effective date to be defined as the date on which accruals begin under a statutory hybrid benefit formula (the beginning of the transition period, in the preceding example) were considered and rejected.

Only amendments that eliminate or reduce benefits under Code Section 411(a)(7) or retirement-type subsidies under Code Section 411(d)(6)(B)(i) that would otherwise accrue due to future service are conversion amendments, so the conversion amendment adoption date is generally the date an amendment that eliminates or reduces such benefits is adopted. However, a conversion amendment is deemed to have been adopted under the following circumstances:

By Operation of Plan Terms—If, under the terms of a plan, a change in the conditions of a participant’s employment results in a reduction of the participant’s benefits that would have accrued in the future under a benefit formula that is not a statutory hybrid benefit formula, and after the change all or a portion of the
participant’s benefit accruals under the plan are determined under a statutory hybrid benefit formula, the plan is treated as if those terms constitute a conversion amendment. The conversion amendment effective date is the date of the change and the date that the relevant plan terms were adopted is treated as the conversion amendment adoption date. For example, if an employee changes from hourly to salaried status and thereby moves from an hourly plan that does not have a statutory hybrid benefit formula to a salaried plan that does have a statutory hybrid benefit formula, by operation of the plans’ terms, the employee’s change in status is deemed to be a conversion amendment.

**Coordination Among Multiple Plans**—If an employer adopts an amendment under which a participant’s benefits under a plan that is not a statutory hybrid plan are coordinated with a separate plan that is a statutory hybrid plan, such as through a reduction (offset) of the benefit under the plan that is not a statutory hybrid plan, the employer is treated as having adopted a conversion amendment.

**Multiple Amendments**—Two or more amendments can result in a conversion amendment, even though none of the amendments individually is a conversion amendment. For example, an employer initially adopts an amendment that freezes benefit accruals under a benefit formula that is not a statutory hybrid benefit formula and then later adopts an amendment to provide accruals under a benefit formula that is a statutory hybrid benefit formula. If the second amendment is adopted within three years of the initial amendment, the two amendments are deemed to be a conversion amendment.

If the second amendment is adopted more than three years after the initial amendment, it is presumed that there has not been a conversion amendment unless the facts and circumstances indicate that there was an intention to adopt the second amendment at the time of the first amendment. If more than one amendment is adopted that reduces or eliminates the benefits that, but for the amendment, a participant would have accrued after the effective date of the amendment under a benefit formula that is not a statutory hybrid benefit formula (and under which the participant was accruing benefits prior to the amendment), then each amendment (after which all or a portion of the participant’s benefit accruals under the plan are determined under a statutory hybrid benefit formula) is separately subject to the rules of this paragraph.

**Mergers, Acquisitions, and Dispositions**—If the employer of an employee changes as a result of a merger, acquisition, or disposition under Code Section 410(b)(6), then the two employers are treated as a single employer for purposes of the conversion amendment rules.

The rules described above for coordination among multiple plans, multiple amendments, and mergers, acquisitions, and dispositions apply both separately and in combination. For example, if the buyer in an acquisition adopts an amendment under which a participant’s benefits under the seller’s plan that is not a statutory hybrid plan are coordinated with a separate plan of the buyer that is a statutory hybrid plan (such as through an offset of the participant’s benefit under the buyer’s plan by the participant’s benefit under the seller’s plan), the seller and buyer are treated as a single employer and they are treated as having adopted a conversion amendment. However, if there is no coordination between the two plans, there is no conversion amendment.

**Opening Account Balances**

A plan that converts to a statutory hybrid plan is not treated as failing to comply with the age discrimination prohibitions of the Code, ERISA, and ADEA merely because benefits attributable to an opening account balance (or opening accumulated percentage of final average compensation) are
substituted for the (A) component described above (under the section *Protections Against Wearaway*), provided the plan satisfies a comparison of benefits at either the annuity starting date or the conversion amendment effective date. Note that the opening account balance rules apply only to a lump-sum based benefit formula.

**Comparison of Benefits at Annuity Starting Date**

The plan must provide that the amount of the benefit payable in an optional form under a lump-sum based benefit formula that is attributable to the opening account balance or opening accumulated percentage is not less than the (A) component benefit under a comparable optional form of benefit. If the benefit under the optional form attributable to the opening account balance or accumulated percentage is less than the (A) component benefit under the comparable optional form of benefit, the benefit attributable to the opening account balance or accumulated percentage must be increased to the extent necessary to provide the minimum benefit. The 2014 final regulations add an example to illustrate that the participant must be provided the benefit attributable to post-conversion service, plus the greater of the benefit attributable to the opening hypothetical account balance or the Code Section 417(e) present value at the annuity starting date of the participant’s pre-conversion benefit.

An optional form of benefit is a comparable optional form of benefit if it was an optional form of benefit within the same generalized optional form of benefit that would have been available to the participant at the same annuity starting date under the terms of the plan as in effect immediately before the effective date of the conversion amendment. If an optional form of benefit is available on the annuity starting date with respect to the benefit attributable to the opening account balance or accumulated percentage, but no optional form within the same generalized optional form of benefit was available at that annuity starting date under the terms of the plan as in effect immediately prior to the conversion amendment effective date, then the plan is treated as if such an optional form of benefit were available immediately prior to the conversion amendment effective date for purposes of the comparison.

**2014 Final Regulations Eliminate Alternative Opening Account Balance Method**

The 2010 proposed regulations provided an alternative opening account balance method, whereby plans could satisfy the conversion requirements with an opening account balance, but without a subsequent comparison of benefits at the annuity starting date, if a number of complicated and burdensome requirements were satisfied. The 2014 final regulations eliminate this alternative approach, recognizing that the proposed method was complex and that a simple rule would not ensure the conversion amendment requirements would be satisfied. If a plan relied on the alternative opening account balance method included in the 2010 proposed regulations, the plan must be amended such that distributions with an annuity starting date in a plan year beginning on or after January 1, 2016 satisfy the 2014 final regulations.

**Accrual Rules**

The 2014 final regulations provide that, for plan years beginning after December 31, 2011, a plan determining any portion of a participant’s accrued benefit under a statutory hybrid benefit formula using a variable interest crediting rate that was less than zero for the prior plan year is not treated as failing to meet the accrual rules for the current plan year merely because the plan assumes the variable rate is zero for the current plan year and all future plan years. The regulations also indicate that special accrual rules for multiple benefit formulas are reserved for future regulatory guidance.
Aon Hewitt Comment: Like the 2010 proposed regulations, the 2014 final regulations do not permit a plan with a cumulative minimum interest rate in excess of zero (e.g., 3%) to use that cumulative minimum for purposes of accrual rule testing, or permit a plan to assume a non-zero interest crediting rate for this purpose regardless of the actual interest crediting rate. This means that plans with investment-based interest crediting rates will be limited in the extent to which they can provide principal credits that vary based on age or service. The IRS has informally indicated that they are separately considering rules for projecting future interest credits for other purposes, such as nondiscrimination testing under Code Sections 410(b) and 401(a)(4) and the application of the benefit limits under Code Section 415, and different rules may apply for those purposes.

Effective Dates and Amendment Deadlines

As noted earlier in this report, PPA statutory effective dates are controlling for certain purposes and the regulatory effective dates control for other purposes.

Statutory Effective Dates

PPA provisions, as amended by WRERA, generally apply for periods beginning on or after June 29, 2005. However, different effective dates apply in the following cases:

Market Rate of Return Limitations

The market rate of return limitations on interest crediting rates apply to a plan in existence on June 29, 2005, other than a collectively bargained plan, for plan years beginning on or after January 1, 2008. However, the plan sponsor may elect to have the limitations apply for any period on or after June 29, 2005 and before the first plan year beginning after December 31, 2007. The amendment to make such an election must be adopted by the last day of the first plan year beginning after December 31, 2008 (or December 31, 2010 in the case of a governmental plan) and the plan must have operated in accordance with the election. These statutory effective dates apply regardless of whether the plan was a statutory hybrid plan or not on June 29, 2005. If the plan was not in existence on June 29, 2005, the market rate of return limitations apply on and after June 29, 2005 or, if later, on and after the date the plan becomes a statutory hybrid plan.

The 2014 final regulations provide that the exclusive list of interest crediting rates and combinations of interest crediting rates that satisfy the market rate of return requirement under Code Section 411(b)(5) applies to plan years that begin on or after January 1, 2016.

Three-Year Minimum Vesting Requirements

The three-year minimum vesting requirements apply to a plan in existence on June 29, 2005, other than a collectively bargained plan, for plan years beginning on or after January 1, 2008. However, the plan sponsor may elect to have the vesting requirements apply for any period on or after June 29, 2005 and before the first plan year beginning after December 31, 2007. The amendment to make such an election must be adopted by the last day of the first plan year beginning after December 31, 2008 (or December 31, 2010 in the case of a governmental plan) and the plan must have operated in accordance with the election. These statutory effective dates apply regardless of whether the plan was a statutory hybrid plan or not on June 29, 2005. If the plan was not in existence on June 29, 2005, the three-year minimum vesting requirements apply to plan years that end on or after June 29, 2005, but only for participants who have an hour of service during a plan year that ends on or after June 29, 2005.
Plan Conversion Requirements

The protections required when converting a traditional defined benefit plan to a statutory hybrid plan apply to a conversion amendment that is both adopted and effective on or after June 29, 2005.

Collectively Bargained Plans

If a plan is maintained pursuant to one or more collective bargaining agreements ratified on or before August 17, 2006, the market rate of return limitations on interest crediting rates and three-year vesting requirement do not apply to plan years beginning before the earlier of: (1) January 1, 2010; and (2) the later of January 1, 2008 and the date on which the last of the agreements terminates without regard to any extension of the agreement on or after August 17, 2006. If a collective bargaining agreement applies to some, but not all, plan participants, the determination of whether a plan is considered collectively bargained is made under the rules for funding-based limits on plan benefits and accruals (Treasury regulation Section 1.436-1(a)(5)(ii)(B)).

Regulatory Effective Dates and Reliance

Except as otherwise specified, the new rules under these final regulations apply to plan years that begin on or after January 1, 2016. The portions of the 2014 final regulations that merely clarify provisions included in the 2010 final regulations apply to plan years beginning on or after January 1, 2011, in accordance with the general effective date of the 2010 final regulations. In addition, the 2014 regulations provide that the regulations which set forth the list of interest crediting rates and combinations of interest crediting rates that satisfy the market rate of return requirement under Code Section 411(b)(5) apply to plan years that begin on or after January 1, 2016.

For periods after the statutory effective date and before the regulatory effective date, the relief of Code Sections 411(a)(13) and 411(b)(5) applies and the requirements of Code Sections 411(a)(13) and 411(b)(5) must be satisfied. As provided in the 2010 final regulations, a plan is permitted to rely on the provisions of the final regulations for purposes of applying the relief and satisfying the requirements of Code Sections 411(a)(13) and 411(b)(5) for periods after the statutory effective date and before the regulatory effective date. For such periods, a plan is also permitted to rely on the provisions of the 2010 proposed regulations, the 2007 proposed regulations and Notice 2007–6 for purposes of applying the relief and satisfying the requirements of Code Sections 411(a)(13) and 411(b)(5).

The preamble to the 2014 final regulations provides a reminder that PPA and any subsequent related regulations should not be construed to create any inference concerning the applicable law prior to the effective dates of Code Sections 411(a)(13) and 411(b)(5). In addition, the regulations should not be construed to create any inference concerning the proper interpretation of Code Sections 411(a)(13) and 411(b)(5) prior to the effective date of the regulations. For example, if prior to the effective date of the 2014 final regulations a plan provided an interest crediting rate that is not provided for under the final regulations, the plan's interest crediting rate for that period could nonetheless satisfy the statutory requirement that an applicable defined benefit plan not provide for interest credits (or equivalent amounts) for any plan year at an effective rate that is greater than a market rate of return.

Plan Amendment Deadlines

PPA generally permits a plan sponsor to delay adopting a plan amendment pursuant to PPA (or pursuant to any regulation issued under PPA) until the last day of the first plan year beginning after December 31,
2008 (after December 31, 2010 for governmental plans). Notice 2009–97 provided that, once final regulations were issued, relief from anti-cutback requirements was expected for a plan amendment eliminating or reducing a Code Section 411(d)(6) protected benefit, provided the elimination or reduction was made only to the extent necessary to enable the plan to meet the requirements of Code Section 411(b)(5) and the amendment was adopted by the last day of the first plan year beginning after December 31, 2009. The Notice also extended to the last day of the first plan year beginning after December 31, 2009 the deadline for amending cash balance and other hybrid defined benefit plans to satisfy the three-year vesting requirements of Code Section 411(a)(13) and the age discrimination, plan conversion, plan termination, preservation of capital, interest crediting, and other requirements of Code Section 411(b)(5).

Notice 2009–97 did not extend the deadline to amend plans to permit payment of a participant’s account balance or accumulated percentage of final average compensation as the lump-sum form of payment amount without a Code Section 411(d)(6) cutback. The deadline for such amendments would have been the last day of the first plan year beginning after December 31, 2008 (after December 31, 2010 for a governmental plan). Without anti-cutback relief, a plan can be amended to eliminate whipsaw only with respect to future accruals (i.e., future principal credits).

The 2010 regulations extended the anti-cutback relief in Notice 2009–97 for the market rate of return rules such that relief is expected to be granted for a plan amendment that eliminates or reduces a Code Section 411(d)(6) protected benefit, provided the elimination or reduction is made only to the extent necessary to enable the plan to meet the market rate of return rules and the amendment is adopted after the 2010 proposed regulations are finalized and before they apply to the plan.

Notice 2011–85 announced delayed effective and applicability dates with respect to certain provisions in the 2010 regulations, so that these provisions would be effective at a future date, not earlier than January 1, 2013. Notice 2011–85 also provided that, when the 2010 proposed regulations were finalized, relief from the requirements of Code Section 411(d)(6) would be granted for certain plan amendments that eliminate or reduce a protected benefit, but only if the plan amendment were adopted by the last day of the first plan year preceding the plan year for which the 2010 proposed regulations, once finalized, apply to the plan, and the elimination or reduction was made only to the extent necessary to enable the plan to meet the requirements of Code Section 411(b)(5). In addition, Notice 2011–85 extended the deadline for amending cash balance and other applicable defined benefit plans, within the meaning of Code Section 411(a)(13)(C), to meet the requirements of Code Section 411(a)(13) (other than Code Sections 411(a)(13)(A)) and 411(b)(5), relating to vesting and other special rules applicable to these plans. Under Notice 2011–85, the deadline for these amendments is the same as the deadline for an amendment that is eligible for the relief under Code Section 411(d)(6) also announced in the Notice.

Notice 2012–61 announced that the regulations described in Notice 2011–85 would not be effective for plan years beginning before January 1, 2014. The 2014 final regulations finalize the 2010 proposed hybrid plan regulations and amend the effective and applicability date of those certain provisions in the 2010 regulations mentioned in the prior paragraph, so that these provisions apply to plan years that begin on or after January 1, 2016. Thus, it appears that the deadline for amending cash balance and other applicable defined benefit plans, within the meaning of Code Section 411(a)(13)(C), to meet the requirements of Code Section 411(a)(13) (other than Code Section 411(a)(13)(A)) and Code Section 411(b)(5) is extended until the end of the plan year ending immediately prior to the first plan year beginning on or after January 1, 2016.
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