Applicability of § 411(b)(5)(B)(i) to Implicit Interest Pension Equity Plans

Notice 2016-67

I. PURPOSE

This notice describes the applicability of the market rate of return limitation rules of § 411(b)(5)(B)(i) and § 1.411(b)(5)-1(d) to a defined benefit plan that expresses a participant's accumulated benefit as the current value of an accumulated percentage of the participant's final average compensation, highest average compensation, or highest average compensation during a limited period of years (a type of plan often referred to as a "pension equity plan" or "PEP"). In particular, this notice addresses the applicability of the market rate of return limitation rules to a type of PEP that applies a deferred annuity factor to the participant's accumulated benefit in order to determine deferred benefits (a type of PEP often referred to as an "implicit interest PEP"). In addition, this notice requests comments on potential proposed regulations that would subject implicit interest PEPs to the market rate of return limitation.

II. BACKGROUND

Section 411(a) provides that, in order to be a qualified plan, a defined benefit plan must satisfy the benefit accrual requirements of § 411(b). Under § 411(b)(1)(H), a defined benefit plan fails to comply with § 411(b) if, under the plan, an employee's benefit accrual ceases, or the employee's rate of benefit accrual is reduced, because of the attainment of any age.

Section 411(b)(5) contains a number of special rules that apply to an applicable defined benefit plan for purposes of section 411(b)(1)(H). The term "applicable defined benefit plan" is defined in § 411(a)(13)(C) and includes a cash balance plan, a PEP, or another plan that has been designated in regulations as an applicable defined benefit plan because it has a similar effect to a cash balance plan or PEP. Final regulations under §§ 411(a)(13) and 411(b)(5) relating to applicable defined benefit plans were published in the Federal Register on October 19, 2010 (75 FR 64123) and on September 19, 2014 (79 FR 56442). These regulations are referred to in this notice as "the hybrid plan regulations." The hybrid plan regulations refer to cash balance plans, PEPs, and other applicable defined benefit plans under § 411(a)(13)(C) as "statutory hybrid plans."

Section 411(b)(5)(B) states that an applicable defined benefit plan is treated as failing to meet § 411(b)(1)(H) unless certain requirements are satisfied. Among these requirements is § 411(b)(5)(B)(i), which provides that an applicable defined benefit plan is treated as failing to meet the age discrimination requirements of § 411(b)(1)(H) if the terms of the plan provide for any interest credit (or equivalent amount) for any plan year at a rate that is greater than a market rate of return.

Under § 1.411(b)(5)-1(d)(1)(ii)(A), an interest credit generally means any of the following adjustments to a participant's accumulated benefit under a statutory hybrid benefit formula, to the extent not conditioned on current service and not made on account of imputed service: "(1) [a]ny increase or decrease for a period, under the terms of the plan at the beginning of the period, that is calculated by applying a rate of interest or rate of return (including a rate of increase or decrease under an index) to the participant's accumulated benefit (or portion thereof) as of the beginning of the period; and (2) [a]ny other increase for a period, under the terms of the plan at the beginning of the period."

Under § 1.411(b)(5)-1(d)(1)(ii)(D), a principal credit means any increase to a participant's accumulated benefit under a statutory hybrid benefit formula that is not an interest credit. Thus, for example, an increase in the accumulated benefit under a PEP formula that is made on account of current service (including an increase on account of higher average compensation) constitutes a principal credit.

Additional final regulations amending the hybrid plan regulations under §§ 411(a)(13) and 411(b)(5) were published in the Federal Register on November 16, 2015 (80 FR 70680). These regulations (referred to in this notice as the "transition regulations") provide an exception from the requirements of § 411(d)(6) to permit a plan to reduce, with respect to benefits that have already accrued, its interest crediting rate from a rate that is impermissible under the hybrid plan regulations to a permissible rate. In addition, the transition regulations delay the applicability date of certain provisions under §§ 411(a)(13) and 411(b)(5) in the final hybrid plan regulations that were scheduled to become effective for plan years beginning on or after January 1, 2016. Under the transition regulations, those provisions generally are first effective for plan years beginning on or after January 1, 2017. This delay in effective date applies to the provisions in § 1.411(b)(5)-1(d) that set forth the list of interest crediting rates and combinations of rates that satisfy the requirement of § 411(b)(5)(B)(i) that a plan not provide an effective rate of return in excess of a market rate of return. See § 1.411(b)(5)-1(f)(2)(i)(B)(1).

III. PEP DESIGNS – DETERMINATION OF BENEFIT PAYABLE AT ANNUITY STARTING DATE

PEPs typically are designed to provide a single-sum distribution equal to the accumulated benefit (that is, the current value of an accumulated percentage of the participant's average compensation) at the time principal credits cease. In addition, for annuity starting dates after principal credits cease, PEPs often provide for increases in the amount of benefits that are payable in order to reflect the time value of money. Some PEPs provide for this increase by explicitly crediting interest on the accumulated benefit after principal credits cease. In the case of such a PEP ("an explicit interest PEP"), a participant is entitled to benefits at an annuity starting date based on the participant's accumulated benefit as of the date principal credits cease, increased by interest credits through the annuity starting date.

Other PEPs provide for increases in annuity benefits for annuity starting dates after principal credits cease by applying a deferred annuity factor to the participant's accumulated benefit as of the date principal credits cease. Such a PEP is often referred to as an "implicit interest PEP" because preretirement interest is implicitly reflected in the deferred annuity factor. One example of an implicit interest PEP is a PEP that defines the accrued benefit (that is, the annual benefit payable at a participant's normal retirement age) as the actuarial equivalent of the accumulated benefit determined as of the date principal credits cease (or the current date, if principal credits have not yet ceased), and determines actuarial equivalence using a deferred annuity factor that reflects preretirement interest.[1]

IV. APPLICATION OF EXISTING REGULATIONS

Under an explicit interest PEP, because the accumulated benefit is adjusted with interest credits to determine the benefit payable at annuity starting dates after principal credits cease, those interest credits are subject to the market rate of return limitation

[1] The deferred annuity factor applied under an implicit interest PEP may also reflect preretirement mortality. For purposes of sections IV and V of this notice, references to preretirement interest include any adjustments for preretirement mortality reflected in a deferred annuity factor.

rules of § 411(b)(5)(B)(i) and § 1.411(b)(5)-1(d). Thus, any amendments necessary to bring the interest crediting rate into compliance with the market rate of return limitation rules under the hybrid plan regulations must be made by the applicable deadline in § 1.411(b)(5)-1(e)(3)(vi)(B)(3) of the transition regulations (generally before the beginning of the first plan year that begins on or after January 1, 2017) in order for the amendments to be eligible for the exception from § 411(d)(6) provided by the transition regulations.

By contrast, under an implicit interest PEP, the preretirement interest that is implicit in applying a deferred annuity factor to the accumulated benefit is not included in the definition of an interest credit under § 1.411(b)(5)-1(d)(1)(ii)(A). This is because the accumulated benefit remains a constant percentage of average compensation and is not adjusted with interest credits after principal credits cease. Thus, under the hybrid plan regulations, no amendment is required to the deferred annuity factors under an implicit interest PEP in order to reduce the preretirement interest that is implicit in those factors to a rate that does not exceed a market rate of return and the exception from § 411(d)(6) under the transition regulations does not apply to such an amendment.

Stakeholders have expressed uncertainty as to whether the market rate of return limitation rules under § 1.411(b)(5)-1(d) of the final hybrid plan regulations apply to implicit interest PEPs. Due to this uncertainty, some plan sponsors of implicit interest PEPs might have believed that the preretirement interest that is implicit in a deferred annuity factor was subject to the market rate of return limitation rules under § 1.411(b)(5)-1(d). As a result, some plan sponsors might have already adopted plan amendments to reduce that interest in accordance with the rules under the transition regulations that apply to amendments reducing interest crediting rates that exceed a market rate of return. For a discussion of the consequences of such a change and the impact of potential future regulations, see section V of this notice.

V. POTENTIAL FUTURE AMENDMENTS TO THE REGULATIONS

Even though the preretirement interest that is implicit in a deferred annuity factor under an implicit interest PEP is not subject to the market rate of return limitation rules in the final hybrid plan regulations, the Treasury Department and the IRS are considering whether to propose amendments to those regulations that would subject implicit preretirement interest to the market rate of return limitation. Comments are requested as to whether such a rule should be proposed. Comments should take into account the statutory intent of § 411(b)(5) to subject interest credits and equivalent amounts to a market rate of return limitation, as well as the difference between interest credits and the interest that is implicit in deferred annuity factors.

If final regulations are ultimately adopted to subject the preretirement interest that is implicit in a deferred annuity factor under an implicit interest PEP to the market rate of return limitation, it is expected that plan sponsors will be given an adequate period of time, after publication of those regulations and before the regulations become applicable, to amend plans to comply with the rule and that in no event will the final rule apply earlier than for plan years that begin on or after January 1, 2018. In addition, it is expected that, if such a final rule is ultimately adopted, the exception to § 411(d)(6) provided in the transition regulations will be expanded to cover required changes in the deferred annuity factor made during the period covered by the existing transition regulations and after that period ends but prior to the applicability date of the new final rule. Thus, if such a rule is adopted and a plan sponsor has already reduced the implicit interest rate in a PEP to a market rate of return under an amendment that would satisfy the existing transition regulations, no further action would be necessary.

However, if no such final rule is adopted to subject the preretirement interest that is implicit in deferred annuity factors to the market rate of return limitation, then any amendment that has already been adopted to change a plan's deferred annuity factors in order to reduce the interest implicit in those factors to a market rate of return would not be eligible for the exception from § 411(d)(6) under the transition regulations. In such a case, a correction would be needed to the extent that the prior amendment violates § 411(d)(6), and guidance relating to permissible corrections would be provided. The Treasury Department and the IRS request comments as to corrections that would appropriately restore benefits that have been reduced by such an amendment but that would not be overly burdensome.

Comments may be submitted in writing on or before February 21, 2017. Comments should be mailed to Internal Revenue Service, CC:PA:LPD:PR (Notice 2016-67), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044, or sent electronically to notice.comments@irscounsel.treas.gov. Please include "Notice 2016-67" in the subject line of any electronic communications. Alternatively, comments may be hand delivered Monday through Friday between the hours of 8:00 a.m. and 4:00 p.m. to CC:PA:LPD:PR (Notice 2016-67), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, D.C. All comments will be available for public inspection and copying.

VI. DRAFTING INFORMATION

The principal author of this notice is Neil Sandhu of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Neil Sandhu at (202) 317-6700 (not a toll-free call).