TaxNewsFlash

United States

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Notice 2016-67: “Implicit interest” and pension equity plans

The IRS today released an advance version of Notice 2016-67.

Notice 2016-67 [PDF 30 KB]:

- Describes applying the market rate of return limitation rules 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”)

- Addresses the application of the market rate of return limitation of section 411(b)(5)(B)(i) and Reg. section 1.411(b)(5)-1(d) to a pension equity plan (PEP) that provides for “implicit interest”

Background

There are several types of defined benefit pension plans. In place of the original defined benefit pension plans that accrue a normal retirement benefit based on a formula tied to years of service and compensation (or a percentage of average or career compensation), companies sometimes “hybrid” defined benefit plans, such as cash balance plans and PEPs. A PEP accrues a retirement benefit by determining a “principal credit” (based on compensation and continued service) and an “interest” credit, each of which generally accrues while the employee is working.

Under changes in the statute and regulations over the last few years, PEPs' interest credits must satisfy certain “market rate limitations.” Some PEPs have explicit interest rate credit rules that provide interest credits even after an employee terminates service. Other PEPs have “implicit” interest credits because the retirement benefit accrued by the employee for retirement is adjusted based on a deferred annuity factor.

The explicit interest PEPs are already required to amend the plan interest credit rate if necessary to meet the section 411(b)(5) regulations on market rate credits (to limit the rate to no more than a market rate of return). These explicit interest PEP amendments generally must be made before the beginning of the first plan year that begins on or after January 1, 2017.

Notice 2016-67

In Notice 2016-67, the IRS noted that companies with implicit interest PEPs have been asking whether they also need to amend their plans for the market rate limitations.

Notice 2016-67 provides that an implicit interest PEP is not currently subject to the market rate of return limitations and does not need to be amended by the deadline (noted above). However, the notice also provides that the IRS and Treasury are considering whether to propose amendments for implicit credit plans as well. The IRS and Treasury are asking for comments. Any later guidance will provide additional time to make any such amendments.