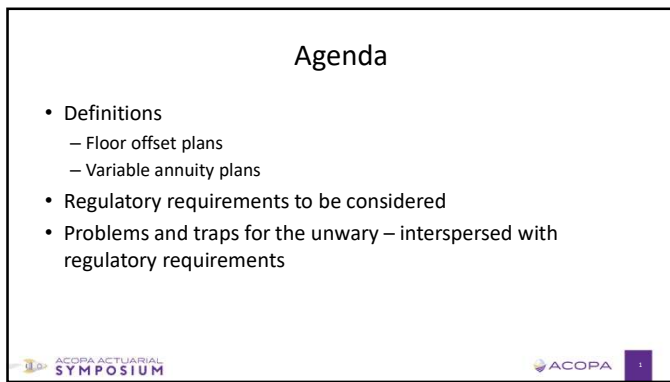
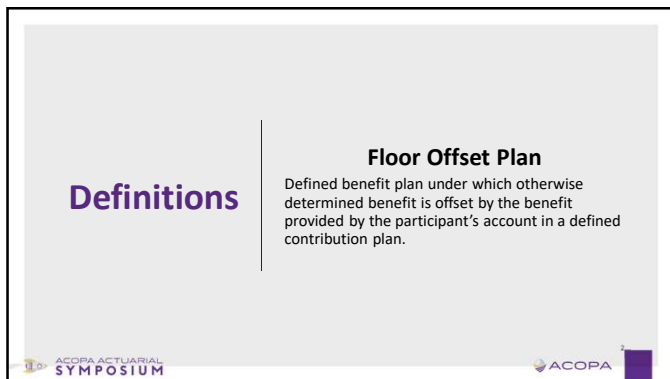




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Definitions

- Floor Offset Plan
 - IRC § 414(k) – certain rules for treatment of a DB plan which provides a benefit derived from Employer contributions which is based partly on the balance of the separate account of a participant
 - Rev. Rul. 76-259 - DB plan offset by PS plan benefits can be qualified; reversing Rev. Rul. 69-502 (citing 414(k)). Still must meet some requirements.

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Definitions

Variable Annuity Plan

Accrued benefit is adjusted up or down based upon comparing rate of return on plan assets (or permitted index) to a specified "hurdle rate".

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Definitions

- Variable Annuity Plan – Example
 - Plan has a hurdle rate of 4% and compares to return on plan assets
 - In 2017, plan assets earned 16%
 - 2018 adjustment factor is $116/104 = 111.54$, and accrued benefits earned in prior years are increased by 11.54%
 - In 2018, plan assets earned 3%
 - 2019 adjustment factor is $103/104 = 99.04$, and accrued benefits earned in prior years are reduced by 0.96%

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Definitions

- Variable Annuity Plans
 - Hurdle rate can be zero, as in case where no comparison made.
 - Can use a defined subset of plan assets or a safe harbor interest rate.
 - Adjustment can be made periodically, but will consider made once annually for this presentation.
 - Adjustment may stop at retirement.
 - May have caps and minimums.

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Regulatory Requirements To Consider

- Definitely determinable benefits
- Accrual rules – 411(b)
- 401(a)(26) & cross-testing
- 417(e) lump sums
- 415(b) limits
- Funding
- Hybrid regulation application

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FLOOR OFFSET PLANS

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Definitely Determinable Requirements

- Per Rev. Rul. 76-259
 - DB plan must specify actuarial basis to determine benefit deemed provided by PS plan
 - Must specify time as of which determination is made of benefit provided by PS plan
 - Both must preclude employer discretion

Accrual Rules

- Rev. Rul. 76-259 – deemed to satisfy accrual rules if
 - DB plan accrued benefit determined without regard to the offset meets § 411(b)(1), **and**
 - Offset is equal to the amount deemed provided by vested portion of the account balance (plus the additional amount provided by any prior distribution from the account)
 - Can specify that offset is based upon only a portion of the vested account balance

401(a)(26)

- General Requirement under 401(a)(26)
 - Plan benefits lesser of:
 - 50 employees or
 - Greater of:
 - 40% of employees or
 - 2 employees (1 if only one employee)
 - Per regs, must provide meaningful benefits

401(a)(26)

- General requirements
 - Benefiting means
 - Benefiting is as defined under 410(b) regulations
 - Refers to increase in accrued benefit
 - Providing “meaningful benefits”
 - Meaningful benefits depends upon facts and circumstances
 - Paul Shultz 2002 memo uses a 0.5% threshold, which has been used by IRS
 - 0.5% will be accepted for this presentation

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401(a)(26)

- Employee is treated as accruing a meaningful benefit if
 - Employee accrues a meaningful benefit under the plan OR
 - Would have accrued a meaningful benefit if the offset were ignored
AND the offset requirements are met

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401(a)(26)

- Employee is treated as accruing a meaningful benefit if (continued):
 - Offset requirements
 - Grandfathered offset – employee doesn't accrue a benefit until new formula benefit exceeds grandfathered benefit
 - Concurrent offset – DB benefit is reduced by benefits under another plan
AND
 - The benefits used to offset actually accrued under the other plan
 - Employees benefiting under the DB plan also benefit under the other plan on a reasonable and uniform basis
 - Benefits used to offset are not used to offset any other plan's benefits

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401(a)(26)

- Employee is treated as accruing a meaningful benefit if (continued):
 - Offset requirements
 - Plan cannot exist primarily to preserve accrued benefits for a small group of employees.

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Example 1 – 401(a)(26) Offset

- Facts
 - HCE-owners are not offset; NCHes are offset by PS benefits
 - HCEs receive maximum pay credit; NHCEs receive 1% of pay as credit
 - All employees receive 6% of pay contribution in PS plan
- Permitted?
 - No
 - Because offset doesn't apply to all participants, not reasonable and uniform
- SO... offset is not disregarded... which means not enough people are benefitting to pass 401(a)(26)

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Example 2 – 401(a)(26) Offset

- Facts
 - All participants are offset by PS benefits
 - HCEs receive maximum pay credit; NHCEs receive 1% of pay as credit
 - HCEs receive a 1% contribution in PS plan; NHCEs receive 6% contribution
- Permitted?
 - No
 - Because participation in offsetting plan is not reasonable and uniform
- SO... offset is not disregarded... which means not enough people are benefitting to pass 401(a)(26)

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Examples – 401(a)(26) Offset

- In both of these cases...
 - NHCE participants DB benefits were offset to \$0
 - Operation causes CBPP to exist primarily to preserve accrued benefits for small group of employees
 - SO, another reason the offset is not disregarded and the plan fails to benefit sufficient # under 401(a)(26)

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Takeaway – 401(a)(26)

- Careful with the aggressive designs result in \$0 benefits
- Providing a minimum 0.5% net benefit may be a safer course

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Cross-Testing

- Want to test on equivalent benefits for combined plan
- Rules of § 1.401(a)(4)-9(b)(2)(v) apply
- Cannot combine unless DB/DC plan
 - Is primarily defined benefit in nature or
 - Consists of broadly available separate plans,
 - Satisfies minimum allocation gateway

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Cross-Testing

- Primarily DB in Nature
 - For more than 50% of NHCEs benefitting:
 - Normal accrual rate for the DB plan
 - Is greater than equivalent accrual rate under DC plan
 - Impact of Offset
 - Only offsets for pre-participation service may be disregarded
 - SO, a concurrent offset is not disregarded

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Cross-Testing

- Consists of broadly available separate plans:
 - Each plan separately satisfies 410(b)
- AND
- Nondiscrimination in amount requirements (tested separately), assuming the average benefit percentage test were satisfied

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Example 1 – Cross Testing

- Facts
 - HCE-owners are not offset; NHCEs are offset by PS benefits
 - HCEs receive maximum pay credit; NHCEs receive 1% of pay as credit
 - Minimum gateway not met; NHCE offset result in \$0 benefit in DB plan
- Cross-testing Permitted?

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Example 1 – Cross Testing

- Cross-testing Permitted?
 - No
 - Offset is not disregarded, so not primarily DB in nature
 - Taking into account offset, DB plan doesn't separately pass 410(b)
- Would have to pass minimum gateway to use cross-testing

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Takeaways – Cross Testing

- Concurrent offsets are not disregarded
- Generally this means...
 - Need to ensure sufficient NHCEs benefit (on a net of offset basis) to pass 410(b) coverage
 - Also could use primarily DB, but higher benefits would be required for NHCEs
 - If you want to avoid minimum gateway requirements

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415(b)

- Accrued benefit must be limited to applicable 415(b) limit
 - If gross benefit limited, then offset not much concern
 - If net benefit limited, then will need precise plan language and operational checking

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Funding

- IRC § 430 rules based upon DB AB and benefit accruing during year.
- As account balance fluctuates, the DB AB will fluctuate as well.
- Problem – Can have significant swings from year to year depending on what happens with account balance. Consider 2008 asset performance. Big drop results in smaller offset, which, in turn, results in increase in DB AB.

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VARIABLE ANNUITY PLANS

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Definitely Determinable Requirements

- Need to define adjustment in a way that precludes employer discretion
- If rate of return on plan assets used, need to define how determined in plan language
 - Similar to issue in cash balance plan where hypothetical interest rate depends on return on plan assets

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Accrual Rules

- Typically, a career average type formula, so want to satisfy 133 1/3% accrual rule
- Accrual with adjustment to NRA is compared

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Accrual Rules

- Not entirely clear what it means to keep all factors constant in applying 133 1/3% rule
 - Current rate of return appears to be what IRS reviewers currently use.
- Can mitigate by use of a floor that is not adjusted.

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Accrual Rules

- Positive adjustments not an issue (\$100 adjusted upwards for n months if higher than \$100 adjusted upwards for n-1 months)
- Negative adjustments pose issue
 - \$100 adjusted by 1.01/1.05 for 20 years is about \$46, while \$100 adjusted by 1.01/1.05 for 5 years is about \$82.
 - Later accrual, as adjusted, more than 133 1/3% of earlier accrual (\$82/\$46 is about 179%).
- Regulations provide relief for statutory hybrid formulas where variable rate less than zero (§ 1.411(b)-1(b)(2)(G)), but not for formulas that are not statutory hybrid formulas.

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Hybrid Plan Rules

- Are VAPs Hybrid Plans?
 - If hurdle rate is at least 5% and uses approved index, no
 - If hurdle rate is less than 5% or doesn't use approved index
 - Might be a formula with effect similar to a lump-sum-based benefit formula and, thus, treated as a statutory hybrid formula

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Hybrid Plan Rules

- Similar to a Lump-Sum-Based Benefit Formula
 - Formula includes the right to adjustments based on the rate of return
 - Early accruals get more adjustment than later accruals because more years until retirement age reached
 - Similar to interest crediting for a cash balance plan
 - And thus has an effect “similar to a lump-sum based benefit formula”

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Hybrid Plan Rules

- Trap – use “low” (less than 5%) hurdle rate.
 - Plan now subject to hybrid rules and faster (i.e., 3-year) vesting required.
 - However, get a pass on protection against loss (aka preservation of capital) requirement (see § 1.411(b)(5)-1(b)(2)(iii)(B)).

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415(b)

- Issue is variable annuity benefit handled for 415(b) purposes
- Two possibilities under § 1.415(b)-1(c)(2) and -1(c)(5)
 - One is to make adjustment to limit to reflect potential increase (similar to making an adjustment for a COLA)
 - Other is to have plan provision so that increases (adjustments) stop when 415(b) limit reached (would take into account years of service or participation as the case may be)
- Problem – plan not clear, which raises issues with communication and audits

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417(e)

- How is lump sum calculated?
- Seems straightforward – take AB and value using 417(e) rates
- AB is accrual to date with projections to NRA, and includes right to adjustments after retirement
 - How do you project to NRA? At what rate? Hurdle rate? Current rate of return?
 - How do you project post-retirement changes to payment?
 - Similar to issues posed by COLA adjustments

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417(e)

- If “low” hurdle rate, then an upwards adjustment may well be expected. Projecting that there will be positive increases in benefit results in a “whipsaw” type of effect.
- AAA draft paper argued for valuing at hurdle rate, but ACOPA disagreed in its comments to AAA.
- “High” hurdle rate (5.5% or above) lessens likelihood of upwards adjustment (Rev. Rul. 76-47 only required adjustment to extent 5 ½% exceeded hurdle rate).

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Funding

- Issue similar to cash balance plan that used interest crediting rate different than segment rates.
 - For cash balance plan, Example 13 in § 1.430(d)-1(f)(9) shows that market related return is projected and discounted at segment rates.
 - Appears that similar projection would occur for variable annuity.
- Problem/trap – have a “funding whipsaw” effect to the extent expected rate of return exceeds hurdle rate.

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Questions??

**Ask Kevin
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Questions??

Reach out with any additional questions

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