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Guide to Retirement Plan Designs

Chapter 65. Cash Balance and Hybrid Pension Plans

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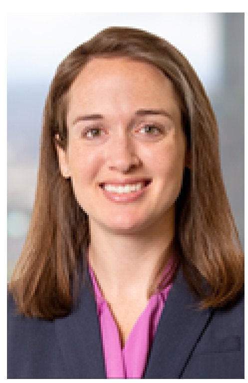

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.10 HYBRID PENSION PLAN BASICS

.10.10 Introduction —

Hybrid pension plans are qualified plans that have characteristics of both defined benefit and defined contribution plans. This chapter addresses the following types of hybrid pension plans, which also are summarized briefly below: cash balance plans, pension equity plans, target benefit plans, age-weighted profit-sharing plans and new comparability plans.

Cash Balance Plans. A cash balance plan is a defined benefit plan designed to mimic the pattern of benefit accrual characteristic of a defined contribution plan by providing a specific “cash balance” within the plan for each participant. This generally is accomplished by establishing hypothetical participant accounts with annual pay-related credits determined in the same manner as employer contributions to defined contribution plans.[1] In addition to the annual pay-related credits, a cash balance plan also generally provides a guaranteed interest credit.[2] Thus, every year each participant's hypothetical account generally is credited with an amount equal to a specified percentage of pay plus earnings on the previous year's account balance at the stated rate of interest.

[1] Employee Benefits Security Administration, Fact Sheet: Cash Balance Pension Plans.

[2] Employee Benefits Security Administration, Fact Sheet: Cash Balance Pension Plans.

A cash balance plan is a defined benefit plan designed to mimic the pattern of benefit accrual characteristic of a defined contribution plan by providing a specific “cash balance” within the plan for each participant. This generally is accomplished by establishing hypothetical participant accounts with annual pay-related credits determined in the same manner as employer contributions to defined contribution plans.[3] In addition to the annual pay-related credits, a cash balance plan also generally provides a guaranteed interest credit.[4] Thus, every year each participant's hypothetical account generally is credited with an amount equal to a specified percentage of pay plus earnings on the previous year's account balance at the stated rate of interest.

[3] Employee Benefits Security Administration, Fact Sheet: Cash Balance Pension Plans.

[4] Employee Benefits Security Administration, Fact Sheet: Cash Balance Pension Plans.

Pension Equity Plans. A pension equity plan is another type of defined benefit plan that defines the benefit in terms of a lump-sum amount. In a pension equity plan, the participant's lump sum generally is defined as a specified percentage of the participant's final pay multiplied by the participant's years of service. Unlike a cash balance plan, a pension equity plan typically does not provide for annual interest credits on a hypothetical account. Instead, the pay component of the formula increases as a participant's pay increases. However, a pension equity plan may provide for interest crediting on the lump-sum amount from termination of employment through benefit commencement.

Target Benefit Plans. A target benefit plan, while technically a defined contribution plan, expresses the target benefit in a manner similar to a defined benefit plan. Using the target benefit formula and the plan's actuarial assumptions, the employer's contribution for each participant is determined and allocated to the participant's account. A key difference between target benefit plans and traditional defined benefit plans is that the promised benefit is only a goal (or target), rather than an unrestricted promise on the employer's part to provide a stated benefit at retirement.

A target benefit plan, while technically a defined contribution plan, expresses the target benefit in a manner similar to a defined benefit plan. Using the target benefit formula and the plan's actuarial assumptions, the employer's contribution for each participant is determined and allocated to the participant's account. A key difference between target benefit plans and traditional defined benefit plans is that the promised benefit is only a goal (or target), rather than an unrestricted promise on the employer's part to provide a stated benefit at retirement.

Age-Weighted Profit-Sharing Plans. An age-weighted profit-sharing plan is a defined contribution plan where contributions are allocated based on plan participants' age and compensation, allowing older participants with fewer years until retirement to receive larger allocations to their accounts (as a percentage of current compensation) than younger participants. Unlike a traditional profit-sharing plan, an age-weighted profit-sharing plan allocates contributions based on participants' projected benefits at retirement age. Because older participants generally need larger contributions to attain their projected retirement benefit, an age-weighted profit-sharing plan can provide different allocations to two participants who are different ages but earning the same amount, since the younger participant has more years for the contributions to grow until retirement age. In order to accomplish this result, age-weighted profit-sharing plans use *cross-testing* rules to satisfy the applicable nondiscrimination requirements. Under the *cross-testing* rules, contributions are converted to equivalent benefit accrual rates, which are then tested for nondiscrimination in a manner similar to the testing for defined benefit plans.

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New Comparability Plans. A new comparability plan is a defined contribution plan that allows employers to divide participants into different groups and determine allocations by projecting what a current contribution would amount to at retirement age. Like age-weighted profit-sharing plans, new comparability plans allow for the possibility of rewarding older participants with fewer years to retirement. However, new comparability plans offer the added benefit of allowing employers to provide different allocations to different classifications of participants. Also like age-weighted profit-sharing plans, new comparability plans are designed to satisfy nondiscrimination testing using *cross-testing* rules.

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Additional Resources: TM Portfolio 352: *Specialized Qualified Plans—Cash Balance, Target, Age-Weighted and Hybrids*; Benefits Guide: *Pre-Approved Retirement Plans*; *Accrual Rules*; *Vesting Rules*; *The Minimum Funding Standard*; *ERISApedia Qualified Plan eSource*, Ch. 1 Types of Plans; TPS ¶ 5560.05 Cash Balance Plans.

.20 Cash Balance Plans

.20.10 Cash Balance Plan Basics —

A cash balance plan is a defined benefit plan under which each participant's benefit is expressed as a hypothetical account balance or a single sum amount, rather than a periodic payment commencing on the participant's normal retirement date, as is typical for a traditional defined benefit plan. Like any other defined benefit plan, cash balance plans are covered by ERISA termination insurance provisions and must make annual premium payments to the Pension Benefit Guaranty Corporation.[5]

[5] ERISA § 4006.

A cash balance plan is a form of defined benefit plan because individual accounts are not actually established on participants' behalf.[6] Instead, participants receive benefits equal to the account balance promised by the plan, regardless of the actual investment experience of the plan's trust. For this reason, and assuming sufficient funding, participants' benefits under a cash balance plan generally are more predictable and secure than those provided under a defined contribution plan.

[6] I.R.C. § 414(j).

A participant's benefit under a cash balance plan typically increases each year by a stated percentage or dollar amount specified under the plan's benefit formula.

Example: A cash balance plan might define a participant's benefit as the account balance that results from a hypothetical annual employer contribution of 2% of the participant's compensation, with earnings on the previous year's ending balance credited at a rate specified in the plan.

Because cash balance plans are defined benefit plans, they are subject to ERISA's joint and survivor annuity and spousal consent requirements.[7] As a result, cash balance plan benefits must be available to participants in the form of an annuity. Actuarial assumptions specified in the plan are used to convert participants' account balances to the various forms of annuity.[8] For more on the QJSA requirements, see *Qualified Survivor Annuities.*

[7] ERISA § 205; I.R.C. 401(a)(11).
[8] I.R.C. 401(a)(25).

For more on specific cash balance plan requirements and design features, see Requirements and Design of Cash Balance Plans.

.20.20 Advantages and Disadvantages of Cash Balance Plans for Employers —

Advantages to employers of cash balance plans may include the following:

• ***Mitigation of financial risk:*** Cash balance plans can be effective tools for employers to mitigate financial risk as compared to traditional defined benefit plans, since cash balance plans generally are less sensitive to interest rate risk. While decreasing interest rates typically result in an increase in traditional defined benefit plan liabilities, decreasing interest rates can reduce a typical cash balance plan's interest crediting rate, thereby offsetting the increase in the cash balance plan's liabilities attributable to the decreasing interest rates and reducing the need to introduce complex interest rate hedging techniques typically used in traditional defined benefit plans. For more, see Interest Credits in Cash Balance Plans.

• ***Relative predictability of cost:*** Cash balance plans also provide employers with relative predictability of cost as compared to traditional defined benefit plans. Because benefit accrual under cash balance plans typically follows that of a defined contribution plan, actuarial costs for cash balance plans generally are more predictable, with actuarial funding levels and accounting expense closely tracking the contribution formula.[9]

• ***Simplified design:*** Cash balance plan benefit formulas are typically more readily understandable than traditional defined benefit plan formulas, making benefits easier to calculate, administer and communicate, and thus more appreciated by some participants.[10]

• ***Simplified administration (as compared to defined contribution plans):*** As compared to defined contribution plans, cash balance plans can be easier to administer. In particular, cash balance plan accounts are bookkeeping accounts only with actual plan assets commingled in one fund, such that separate accounts do not have to be maintained for each participant and earnings do not have to be allocated among participants.[11]

• ***Universal coverage:*** As employers have shifted the primary retirement vehicle from traditional defined benefit plans to 401(k) plans, employees who are unable to contribute to the 401(k) plan receive no employer matching contributions and are left with minimal (or no) retirement savings. Cash balance plans can fill this gap since they generally cover all eligible employees, similar to a traditional defined benefit plan.[12]

• ***Closer alignment with changing workforce demographics and career progression:*** As compared to traditional defined benefit plans, cash balance plans generally are more consistent with changing workforce demographics and career progression, given that cash balance plan benefits generally are more portable than traditional defined benefit plan benefits, and employees may change employers and careers many times during their working lives.[13]

[9] I.R.C. § 411(b).

[10] TM Portfolio 352 V.B.: Plan Design Considerations.

[11] Client Letter–Cash Balance Plans.

[12] TM Portfolio 352, Worksheet 6, Sample Cash Balance Plan Provisions (Excerpt).

[13] Client Letter–Cash Balance Plans.

Disadvantages to employers of cash balance plans may include the following:

• ***Increased cost:*** While cash balance plans may afford employers with relative predictability of cost as compared to traditional defined benefit plans, overall costs associated with cash balance plans may be greater than those of traditional defined benefit plans.

Example: Payment of benefits in the form of lump-sum distributions rather than monthly benefits results in an earlier reduction in plan assets and potential loss of gains from long-term investments, lower returns, lower assets and higher contributions over time.[14]

[14] TM Portfolio 352 V.B.: Plan Design Considerations.

- ***Conversion issues:*** The conversion of a traditional defined benefit plan to a cash balance plan may result in certain participants receiving larger than expected benefits in retirement, and other participants receiving smaller than expected benefits in retirement, giving rise to potential claim and litigation risk. The complexity of the conversion process combined with the related participant risk puts significant pressure on the participant education and communication process. For more, see *Cash Balance Plan Conversions.*

- ***Administrative complexity (as compared to traditional defined benefit plans):*** As compared to traditional defined benefit plans, cash balance plans can be more difficult to administer because they involve participant-level recordkeeping similar to that required for defined contribution plans. In particular, complete and accurate participant information is necessary in order to correctly maintain and update participant account balances. For more, see *ERISA and Other Benefit Disclosure Requirements.*

- ***Legal complexity:*** Due to the unique nature of cash balance plans and the ever-evolving state of guidance, there is arguably additional complexity associated with ensuring legal compliance for cash balance plans. However, the IRS has opened the determination letter program for the period from Sept. 1, 2019, through Aug. 31, 2020, to allow submission of cash balance plans for favorable determination letters. For more, see *Determination Letter Process.*

.20.30 Advantages and Disadvantages of Cash Balance Plans for Employees —

Advantages to employees of cash balance plans may include:

- ***Guaranteed benefits:*** For employees, cash balance plans can be attractive because, typically, accounts earn a guaranteed rate of interest rather than being dependent upon the investment performance of an actual account, as is the case in a defined contribution plan. Cash balance plan benefits also are insured by the PBGC.[15]

- ***Automatic coverage:*** Cash balance plans usually cover all employees, or large segments of an employer's population, without requiring participant contributions. Therefore, unlike traditional defined contribution plans, an employee generally does not have to decide whether to participate, how much to contribute, or which investment options to select.[16]

- ***Faster accrual of benefits:*** Benefits in a cash balance plan generally accrue faster in the early years of employment than under most traditional defined benefit plans. As a result, employees who tend to change jobs frequently generally benefit more from cash balance plans than traditional defined benefit plans.[17] For more, see *Accrual Rules.*

- ***Simplified design:*** Cash balance plans describe benefits in terms of an account balance for each participant, which generally is easier for participants to understand than traditional defined benefit plan formulas.[18]

- ***Reduced risk:*** Similar to traditional defined benefit plans, but unlike defined contribution plans, the employer bears all of the investment risk in a cash balance plan.[19]

- ***Enhanced portability:*** Unlike a traditional defined benefit plan benefit, a participant's cash balance account can be rolled over into an individual retirement account or a new employer's plan following termination of employment.[20]

- ***Availability of annuity options:*** As defined benefit plans, cash balance plans are required to offer participants annuity forms of payment in addition to the lump-sum benefit, which is not required in a defined contribution plan. The availability of an annuity option provides cash balance plan participants additional flexibility when planning for retirement.[21]

[15] TM Portfolio 352 V.B.: Plan Design Considerations.

[16] Employee Benefits Security Administration, Fact Sheet: Cash Balance Pension Plans.

[17] Client Letter–Cash Balance Plans.

[18] TM Portfolio 352 V.B.: Plan Design Considerations.

[19] TM Portfolio 352 V.B.: Plan Design Considerations.

[20] Client Letter–Cash Balance Plans.

[21] TM Portfolio 352 V.B.: Plan Design Considerations.

Disadvantages to employees of cash balance plans for employees may include:

- ***Conversion complexity:*** The transition from a traditional defined benefit plan to a cash balance plan can be confusing for participants. For more, see *Cash Balance Plan Conversions.*

- ***No in-service withdrawal options:*** Unlike defined contribution plans, cash balance plans do not offer in-service distributions.[22]

- ***Reduced effectiveness for certain participants:*** Cash balance plans reflect participants' average salary over their full career with an employer. As a result, for participants with quickly rising compensation or in the middle of their careers, cash balance plans may be a less effective retirement vehicle than a traditional defined benefit plan.[23]

[22] TM Portfolio 352 V.B.: Plan Design Considerations.

[23] TM Portfolio 352 V.B.: Plan Design Considerations.

.30 Requirements and Design of Cash Balance Plans

.30.10 Accumulated Benefit and Lump Sum-Based Benefit Formula —

The final hybrid plan regulations (generally referred to in this chapter as the hybrid regulations) set forth certain qualification requirements for a statutory hybrid plan, which is a defined benefit plan that contains a statutory hybrid benefit formula.[24] The statutory hybrid benefit formula is used to determine all or part of a participant's accumulated benefit under the plan, which is the current balance of the participant's hypothetical account.[25] Although the accumulated benefit described in the hybrid regulations is different from a participant's accrued benefit under I.R.C. § 411(a)(7), a statutory hybrid plan may express a participant's accumulated benefit as the current balance of a hypothetical account, even if the plan defines the participant's accrued benefit as an annuity beginning at normal retirement age that is actuarially equivalent to the balance of the participant's hypothetical account.[26]

[24] 26 C.F.R. § 1.411(a)(13)-1.

[25] 26 C.F.R. § 1.411(a)(13)-1.

[26] 26 C.F.R. § 1.411(a)(13)-1(d)(2).

A statutory hybrid benefit formula is a benefit formula that is either a lump sum-based benefit formula or a formula that has an effect similar to a lump sum-based benefit formula.[27]

[27] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(i).

Lump Sum-Based Benefit Formula. A lump sum-based benefit formula is a benefit formula that expresses a participant's accumulated benefit as the current balance of a hypothetical account maintained for the participant in the form of a single-sum dollar amount.[28] Whether a benefit formula is a lump sum-based benefit formula is determined based on how participants' accumulated benefits are expressed under the terms of the plan, and the availability of a single-sum payment as an optional form of payment is irrelevant to this determination.[29] However, a benefit formula does not constitute a lump sum-based benefit formula unless:

[28] 26 C.F.R. § 1.411(a)(13)-1(d)(3)(i).

[29] 26 C.F.R. § 1.411(a)(13)-1(d)(3)(i).

- distribution of benefits under the formula in the form of a single-sum payment equals the accumulated benefit under that formula (unless otherwise required under I.R.C. § 411(d)(6)); and
- the portion of the participant's accrued benefit under the formula and the then-current balance of the hypothetical account are actuarially equivalent, determined using reasonable actuarial assumptions, either upon the participant's normal retirement age or annuity starting date.[30]

[30] 26 C.F.R. § 1.411(a)(13)-1(d)(3)(i).

A lump sum-based benefit formula is a benefit formula that expresses a participant's accumulated benefit as the current balance of a hypothetical account maintained for the participant in the form of a single-sum dollar amount.[31] Whether a benefit formula is a lump sum-based benefit formula is determined based on how participants' accumulated benefits are expressed under the terms of the plan, and the availability of a single-sum payment as an optional form of payment is irrelevant to this determination.[32] However, a benefit formula does not constitute a lump sum-based benefit formula unless:

[31] 26 C.F.R. § 1.411(a)(13)-1(d)(3)(i).

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- distribution of benefits under the formula in the form of a single-sum payment equals the accumulated benefit under that formula (unless otherwise required under I.R.C. § 411(d)(6)); and
- the portion of the participant's accrued benefit under the formula and the then-current balance of the hypothetical account are actuarially equivalent, determined using reasonable actuarial assumptions, either upon the participant's normal retirement age or annuity starting date.[33]

[33] 26 C.F.R. § 1.411(a)(13)-1(d)(3)(i).

Formula with an Effect Similar to a Lump Sum-Based Benefit Formula. A benefit formula that is not a lump sum-based benefit formula has an effect similar to a lump sum-based benefit formula if the formula provides that the participant's accumulated benefit is expressed as a benefit that includes the right to adjustments for a future period, and the total amount of those adjustments is reasonably expected to be smaller for the participant than for any similarly-situated younger participant.[34] A right to adjustments for a future period is the right to any changes in the dollar amount of benefits over time, regardless of whether those adjustments are expressed as interest credits.[35]

However, post-annuity starting date adjustments in the amount payable to a participant (e.g., cost-of-living increases), certain variable annuity benefit formulas and benefits properly attributable to certain employee contributions are all disregarded for purposes of determining whether a benefit formula has an effect similar to a lump sum-based benefit formula.[36] In addition, a benefit formula that provides for a reduction in a participant's benefit payable at early retirement age due to early commencement (with the result that the normal retirement benefit is greater than the early retirement benefit) is not treated as having an effect similar to a lump sum-based benefit formula, provided that the participant's normal retirement benefit is no less than the normal retirement benefit of a similarly-situated younger participant.[37]

[34] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(ii).
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[38] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(ii).
[39] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(ii).
[40] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(ii).
[41] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(ii).

.30.20 Annual Pay-Related Credits in Cash Balance Plans —

Typical Pay-Related Credits Design. Cash balance plan designs vary, but usually do not define benefits as a percentage of final or career average pay or as a flat dollar amount per year of service. Like defined contribution plans, cash balance plans often provide annual pay-related credits, determined in a manner similar to that for determining employer contributions to a defined contribution plan. Benefits are usually defined as a stated annual contribution allocated to a participant's hypothetical account, with the contributions growing at a stated rate of interest each year.[42]

[42] Employee Benefits Security Administration, Fact Sheet: Cash Balance Pension Plans.

Cash balance plan designs vary, but usually do not define benefits as a percentage of final or career average pay or as a flat dollar amount per year of service. Like defined contribution plans, cash balance plans often provide annual pay-related credits, determined in a manner similar to that for determining employer contributions to a defined contribution plan. Benefits are usually defined as a stated annual contribution allocated to a participant's hypothetical account, with the contributions growing at a stated rate of interest each year.[43]

[43] Employee Benefits Security Administration, Fact Sheet: Cash Balance Pension Plans.

Example: A traditional defined benefit plan might provide for benefits equal to a specified percentage of final average pay multiplied by a participant's years of service (a *final average pay plan*) or as a specified dollar amount per month multiplied by a participant's years of service (a *flat dollar amount plan*). In contrast, a cash balance plan might provide for benefits to accrue at a rate of a specified percentage of pay per year plus interest at a fixed interest rate.

Definitely Determinable Benefit Requirement. A cash balance plan must provide systematically for the payment of definitely determinable benefits to participants over a period of years, usually for life, after retirement.[44] A cash balance plan benefit formula that is based on a portion of a participant's pay (e.g., a special bonus, pay for a certain month or pay in excess of a certain amount) multiplied by a set factor generally is still considered to be definitely determinable, even though the amount of that pay varies within the discretion of the employer, unless the plan terms allow the employer to manipulate pay credits.[45]

[44] 26 C.F.R. § 1.401-1(b)(1)(i).

[45] Memorandum for Employee Plans (EP) Employees, Control Number: TE/GE-04-0417-0014, April 7, 2017.

A cash balance plan must provide systematically for the payment of definitely determinable benefits to participants over a period of years, usually for life, after retirement.[46] A cash balance plan benefit formula that is based on a portion of a participant's pay (e.g., a special bonus, pay for a certain month or pay in excess of a certain amount) multiplied by a set factor generally is still considered to be definitely determinable, even though the amount of that pay varies within the discretion of the employer, unless the plan terms allow the employer to manipulate pay credits.[47]

[46] 26 C.F.R. § 1.401-1(b)(1)(i).

[47] Memorandum for Employee Plans (EP) Employees, Control Number: TE/GE-04-0417-0014, April 7, 2017.

In other words, an employer's inherent ability to determine a participant's annual Form W-2 compensation and other forms of compensation outside of plan terms doesn't cause a benefit formula to fail to be definitely determinable.[48] As a result, a cash balance plan formula based on partial pay, such as a special bonus or pay for a specific month, is definitely determinable regardless of the employer's inherent ability to determine the amount of the participant's *special bonus* or *monthly pay* outside of plan terms.[49] Similarly, a cash balance plan formula that bases the hypothetical allocation on a multiplier of pay that exceeds a specified dollar amount also is definitely determinable unless the plan terms provide the employer with discretion to determine the pay used for the benefit formula.[50] As long as the plan terms identify a *stipulated formula* that is not subject to the employer's discretion, the benefits are definitely determinable.[51] However, if the plan terms give the employer discretion to determine the pay used for the benefit formula (e.g., an employee's annual compensation less an amount designated by the employer), the pay-related credits would not be definitely determinable.[52]

[48] Memorandum for Employee Plans (EP) Employees, Control Number: TE/GE-04-0417-0014, April 7, 2017.

[49] Memorandum for Employee Plans (EP) Employees, Control Number: TE/GE-04-0417-0014, April 7, 2017.

[50] Memorandum for Employee Plans (EP) Employees, Control Number: TE/GE-04-0417-0014, April 7, 2017.

[51] Memorandum for Employee Plans (EP) Employees, Control Number: TE/GE-04-0417-0014, April 7, 2017.

[52] Memorandum for Employee Plans (EP) Employees, Control Number: TE/GE-04-0417-0014, April 7, 2017.

.30.30 Interest Credits in Cash Balance Plans —

Cash balance plans generally provide for interest credits that accrue at the same time as the annual pay credits and are not contingent on the performance of future services. As a result, if a participant terminates employment and defers distribution to a later date, interest credits continue to be credited to that participant's hypothetical account through benefit commencement. Benefits attributable to interest credits are included in the definition of the accrued benefit under 26 C.F.R. § 1.411(a)-7(a).[53]

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[54] 26 C.F.R. § 1.411(a)-7(a).

Interest credits generally are determined with reference to either an external index, such as the rate on one-year Treasury bills, or a specified rate that is unrelated to an external index, such as a fixed rate chosen by the employer.[55] The rate used must be *fixed* in the sense that it must be stated in the plan document.[56] Otherwise, the plan will fail to meet the definitely determinable benefit requirement for defined benefit plans.[57]

[55] Employee Benefits Security Administration, Fact Sheet: Cash Balance Pension Plans.

[56] I.R.C. § 411(b)(5)(B)(i)(I).

[57] Internal Revenue Service Tax Exempt and Government Entities, Chapter 11 Cash Balance Plans.

Permissible Interest Rates. A cash balance plan must satisfy the accrual requirements of I.R.C. § 411(b) in order to be qualified under I.R.C. § 401(a). Under I.R.C. § 411(b)(5)(B)(i), a statutory hybrid plan is treated as failing to satisfy the requirements of I.R.C. § 411(b)(1)(H) (which provides that the rate of a participant's benefit accrual must not be reduced because of the attainment of any age) if the terms of the plan provide any interest credit (or an equivalent amount) for any plan year at a rate that is in excess of a market rate of return. Under the hybrid regulations, an interest crediting rate is not in excess of a market rate of return only if plan terms provide that the interest credit for each plan year is determined using one of the interest crediting rates specified in the hybrid regulations, or at a rate that does not exceed one of those rates.

The hybrid regulations provide a list of interest crediting rates and combinations of rates that satisfy the market rate of return limitations.[58] The interest crediting rates can be broadly characterized as either investment-based rates or rates that are not investment-based rates.[59]

[58] 80 Fed. Reg. 70680; *see* 26 C.F.R. § 1.411(b)(5)-1(d)(1)(iii), 26 C.F.R. § 1.411(b)(5)-1(d)(1)(vi) and 26 C.F.R. § 1.411(b)(5)-1(d)(6)(i), 80 Fed. Reg. 70680 (Nov. 16, 2015).

[59] 80 Fed. Reg. 70680; *see* 26 C.F.R. § 1.411(b)(5)-1(d)(1)(iii), 26 C.F.R. § 1.411(b)(5)-1(d)(1)(vi) and 26 C.F.R. § 1.411(b)(5)-1(d)(6)(i), 80 Fed. Reg. 70680 (Nov. 16, 2015).

An investment-based rate is a rate of return provided by actual investments, taking into account the return attributable to any change in the value of underlying investments.[60] A rate of return that is based on the rate of return for an index that measures the change in value of investments also can be considered an investment-based rate.[61] Permissible crediting rates under the hybrid regulations that are investment-based rates include the rate of return on certain regulated investment companies (RICs) and the rate of return on plan assets.[62]

[60] 80 Fed. Reg. 70680; *see* 26 C.F.R. § 1.411(b)(5)-1(d)(1)(iii), 26 C.F.R. § 1.411(b)(5)-1(d)(1)(vi) and 1.411(b)(5)-1(d)(6)(i), 80 Fed. Reg. 70680 (Nov. 16, 2015).

[61] 80 Fed. Reg. 70680; *see* 26 C.F.R. § 1.411(b)(5)-1(d)(1)(iii), 26 C.F.R. § 1.411(b)(5)-1(d)(1)(vi) and 26 C.F.R. § 1.411(b)(5)-1(d)(6)(i), 80 Fed. Reg. 70680 (Nov. 16, 2015).

[62] 26 C.F.R. § 1.411(b)(5)-1(d)(5).

Rates that are not investment-based rates are either fixed rates or bond-based rates, such as yields to maturity of bonds.[63] Permissible crediting rates under the hybrid regulations that are not investment-based rates include the third segment rate described in I.R.C. § 417(e)(3)(D) or I.R.C. § 430(h)(2)(C)(iii), the yield on 30-year Treasury Constant Maturities and a fixed 6% rate of interest.[64]

[63] 26 C.F.R. § 1.411(b)(5)-1(d)(5).

[64] 26 C.F.R. § 1.411(b)(5)-1(d)(5).

Certain annual (or more frequent) floors are permitted in combination with the bond-based rates, and cumulative floors (in excess of the cumulative zero floor required under I.R.C. § 411(b)(5)(i)(II)) are permitted in combination with either the bond-based rates or the investment-based rates.[65]

[65] 26 C.F.R. § 1.411(b)(5)-1(d)(6).

An interest crediting rate is not in excess of a market rate of return if the rate can never be in excess of a rate set forth in the hybrid regulations (e.g., an interest crediting rate that always equals the lesser of the yield on the 30-year Treasury Constant Maturities and a fixed 7% interest rate is not in excess of a market rate of return because it can never be in excess of the yield on 30-year Treasury Constant Maturities).[66] Similarly, if a statutory hybrid plan determines an interest credit by applying the greater of two or more different rates to the accumulated benefit, the effective interest crediting rate is not in excess of a market rate of return if each of the different rates would independently satisfy the regulatory requirements.[67] Finally, a statutory hybrid plan does not provide an effective interest crediting rate that is in excess of a market rate of return merely because the plan determines an interest credit by applying different rates to different predetermined portions of the accumulated benefit, provided that each rate would independently satisfy the regulatory requirements if the rate applied to the entire accumulated benefit.[68]

[66] 26 C.F.R. § 1.411(b)(5)-1(d)(1)(v).

[67] 26 C.F.R. § 1.411(b)(5)-1(d)(1)(vi).

[68] 26 C.F.R. § 1.411(b)(5)-1(d)(1)(vii).

Timing Rules. A plan that credits interest must specify how the plan determines interest credits and how and when the interest credits are credited.[69] Interest credits must be provided on an annual or more frequent periodic basis, and interest credits for each interest crediting period must be credited as of the end of that period.[70] In addition, there are specific rules regarding the method and timing of interest credits.[71]

[69] 26 C.F.R. § 1.411(b)(5)-1(d)(1)(iv)(A).
[70] 26 C.F.R. § 1.411(b)(5)-1(d)(1)(iv)(C).
[71] 26 C.F.R. § 1.411(b)(5)-1(d)(1)(iv)(C).

Preservation of Capital Requirement. The preservation of capital requirement effectively precludes a negative interest crediting rate by requiring that a participant's benefit under a cash balance plan be no less than the amount determined by adding all credits to the participant's cash balance account other than interest credits.[72] Special rules apply in the case of participants with multiple annuity starting dates or five or more breaks in service.[73]

[72] 26 C.F.R. § 1.411(b)(5)-1(d)(2).
[73] 26 C.F.R. § 1.411(b)(5)-1(d)(1)(iv)(C).

Changes to Interest Crediting Rate. The right to future interest credits determined in the manner specified under a cash balance plan and not conditioned on future service is a factor that is used to determine a participant's accrued benefit for purposes of I.R.C. § 411(d)(6).[74] As a result, if benefits have accrued under the terms of a cash balance plan that entitle the participant to future interest credits, an amendment to the plan to change the interest crediting rate must satisfy the requirements of I.R.C. § 411(d)(6) if the revised rate under any circumstances could result in interest credits that are smaller as of any date after the amendment date than the interest credits that would be provided without regard to the amendment.[75]

[74] 26 C.F.R. § 1.411(b)(5)-1(e)(3)(i).
[75] 26 C.F.R. § 1.411(b)(5)-1(e)(3)(i).

A plan is not treated as providing smaller interest credits in the future merely because of an amendment that changes the plan's interest crediting rate with respect to future interest credits from one of the safe harbor market rates of return (e.g., a fixed rate of interest or a rate based on Treasury bonds with the margins specified in the hybrid regulations) to the rate of interest on long-term investment grade corporate bonds (i.e., the third segment rate under I.R.C. § 417(e) or I.R.C. § 430(h)), if the regulatory requirements are satisfied.[76] Consequently, the change in the interest crediting rates would not reduce benefits because it is expected that an interest crediting rate that equals the third segment rate would not provide smaller interest credits as of any date after the applicable amendment date than the prior safe harbor interest crediting rate, except in rare and unusual circumstances.[77] This special rule is only available if:

[76] 26 C.F.R. § 1.411(b)(5)-1(e)(3)(i).
[77] 26 C.F.R. § 1.411(b)(5)-1(e)(3)(i).

- the change applies to interest credits to be credited after the effective date of the amendment;
- the effective date of the amendment is at least 30 days after adoption;
- 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
- any fixed annual floor is retained after the amendment to the extent required under the hybrid regulations.[78]

[78] 26 C.F.R. § 1.411(b)(5)-1(e)(3)(i).

If a cash balance plan is amended to change the interest crediting rate and, under any circumstances, the revised rate could result in interest credits that are smaller than the interest credits that would be provided without regard to the amendment, there are two methods commonly used to satisfy the requirements of I.R.C. § 411(d)(6), the *A plus B approach* and the *wearaway approach*.[79]

[79] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

Under the A plus B approach, the plan maintains two separate hypothetical accounts, with the "A" original account continuing to accumulate interest credits at the old interest crediting rate, with no additional principal credits, and a new "B" account with an opening balance of zero. Future principal credits are credited to the "B" account, and interest credits are credited on the "B" account at the new interest crediting rate. The participant's benefit is based on the sum of the "A" and "B" accounts.[80]

[80] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

Example (A plus B approach): Assume a $10,000 cash balance account when the change in interest crediting rate becomes effective, Jan. 1, 2020. The principal credit is $500 for the first year and $600 for the second year. Principal credits and interest credits are added at the end of the year. The interest crediting rate is reduced from a fixed rate of 6% to a fixed rate of 5%, with the former rate used to determine interest credits to the A account, and the latter rate used to credit principal and interest credits to the B account. The total account balance on Dec. 31, 2021, is the sum of the A account ($10,000 plus 6% interest, or $600, in 2020, plus 6% interest on $10,600, or $636, in 2021, for a total of $11,236) and B account (a $500 principal credit for 2020 plus 5% interest, or $25 dollars, plus a $600 principal credit for 2021 for a total of $1,125), or $12,361.[81]

[81] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

> ***Practice Tip:*** If the participant is not earning any principal credits at the date of change of the interest crediting rate, then he or she does not have a *B* account. To avoid any cutback in benefits under the A plus B approach, the participant would continue to receive interest credits at the prior interest crediting rate.[82]

[82] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

Under the wearaway approach, the account balance is the greater of either:

- the hypothetical account balance at the date of change plus interest credits at the old interest crediting rate; or
- the hypothetical account balance at the date of change plus principal credits and interest credits at the new interest crediting rate.[83]

[83] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

All participants may be subject to wearaway, including those who were no longer earning principal credits as of the date of the amendment changing the interest crediting rate.[84]

[84] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

Example (wearaway approach): If a plan using a 6% interest crediting rate is amended to use a 5% interest crediting rate, the protected account balance is increased at the prior fixed rate with no further principal credits, while the total account balance is increased at the new rate plus principal credits. In this situation, by the end of the first year the protected account balance has *worn away* and the new total account balance is the larger amount.[85]

[85] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

The wearaway approach cannot be used for participants who are no longer earning principal credits as of the date of the amendment changing the interest crediting rate if the combination of the old and new interest crediting rates would not meet the market rate of return restrictions.[86] This is because if the participant is not earning any additional principal credits, there are no new benefit accruals to wear away the protected benefit, and the wearaway approach essentially defaults to applying the greater of the old or new interest crediting rate to the participant's hypothetical account balance.[87] If the combination of the old and new interest crediting rates would fall within the market rate of return rules, then the wearaway approach could be used for all participants, including those who were no longer earning principal credits as of the date of the amendment changing the interest crediting rate.[88]

[86] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

[87] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

[88] IIRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

Cash balance plans that used above-market rates of return were provided with transition relief under IRS rules, allowing them to amend their plans to conform those rates with the market rate-of-return limitations without violating the I.R.C. regulations prohibiting benefit reductions.[89] In order to take advantage of the transition relief, cash balance plans generally were required to be amended prior to Jan. 1, 2017, for interest crediting periods beginning on and after Jan. 1, 2017.[90]

[89] 26 C.F.R. § 1.411(b)(5)-1(e)(3)(vi).

[90] 26 C.F.R. § 1.411(b)(5)-1(e)(3)(vi).

Investment Measures. Similar to nonqualified deferred compensation arrangements, it is theoretically possible to design a cash balance plan to permit participants to designate investments and credit interest to participants' hypothetical accounts based on the performance of the investment choices. However, because of the significant concerns relating to the use of these plan designs, the Treasury Department and the IRS are continuing to study the issues raised by these designs, and it is possible that the Treasury Department and IRS will conclude that such plan designs are not permitted.[91]

[91] 80 Fed. Reg. 70680 (Nov. 16, 2015).

Despite these concerns, the Treasury Department and IRS were aware that some of these plans may contain one or more hypothetical investment options that provide for a rate of return that is not permitted under the hybrid regulations.[92] As a result, the provisions of the hybrid regulations were able to be applied separately to correct each impermissible hypothetical investment option.[93] Alternatively, with respect to a plan that permitted a participant to choose an interest crediting rate from among a menu of hypothetical investment options on Sept. 18, 2014, pursuant to plan provisions that were adopted on or before Sept. 18, 2014, the entire menu of hypothetical investment options was allowed to be treated as an impermissible investment-based rate for which there was no permitted investment-based rate with similar risk and return characteristics. As such, such a plan could have been amended to eliminate participants' ability to choose an interest crediting rate from among a menu of hypothetical investment options.[94]

[92] 80 Fed. Reg. 70680 (Nov. 16, 2015).
[93] 80 Fed. Reg. 70680 (Nov. 16, 2015).
[94] 80 Fed. Reg. 70680 (Nov. 16, 2015).

Special Rules upon Plan Termination. Some plan sponsors may have considered terminating their cash balance plans to reduce their ongoing interest credits. In particular, employers who take this approach are hoping to terminate the current plan and establish a new plan with a different interest crediting rate, and therefore avoid the need to protect the old interest crediting rate on participants' accrued hypothetical account balances.[95]

[95] IRS Issue Snapshot–How to Change Interest Crediting Rates in a Cash Balance Plan.

In response to this concern, special rules apply with respect to interest crediting rates after a plan termination, so that the employer cannot completely ignore the old interest crediting rate.[96] In particular, subsequent to a cash balance plan termination, the interest crediting rate used to determine a participant's accumulated benefit for interest crediting periods that end after the plan termination date must be equal to the average of the interest rates used under the plan during the five-year period ending on the plan termination date.[97] For plans that use investment-based interest crediting rates, the 5-year average is determined using the second segment rate under I.R.C. § 430(h)(2)(C)(ii) instead of the plan's actual interest crediting rates.[98]

[96] 26 C.F.R. § 1.411(b)(5)-1(e)(2).
[97] 26 C.F.R. § 1.411(b)(5)-1(e)(2).
[98] 26 C.F.R. § 1.411(b)(5)-1(e)(2).

Practice Tip: IRS agents will review whether a bona-fide plan termination occurred when an employer terminates a cash balance plan and reestablishes it shortly thereafter with different interest crediting rates.[99]

[99] IRS Issue Snapshot-How to Change Interest Crediting Rates in a Cash Balance Plan.

.30.40 Accrued Benefits in Cash Balance Plans —

As a defined benefit plan, a cash balance plan must satisfy the accrued benefit requirements in 26 C.F.R. § 1.411(b)-1, which generally regulates the rate at which benefits can be earned and requires that a defined benefit plan's normal retirement benefit meet at least one of three tests that are designed to prevent excessive *backloading* of benefits. The theory behind these rules is that highly compensated employees generally tend to remain with an employer longer and, if a plan provides low accruals in a participant's early years and much higher accruals in later years, this will have a discriminatory effect.

> ***Practice Tip:*** All of the three tests allow unlimited *frontloading* of benefits—a higher accrual rate in a participant's early years of service than in later years—but employers will still have to be careful about reducing benefit accruals because of the attainment of any age, as prohibited by I.R.C. § 411(b).

The three tests are:

- ***the fractional test,*** which generally requires that normal retirement benefits accrue no less quickly than ratably over an employee's career;

- ***the three percent test,*** which generally requires that an employee accrue at least 3% of his or her normal retirement benefit per year until 100% of that benefit has been accrued; and

- ***the 133 1/3 percent test,*** which generally requires that an employee's rate of benefit accrual in any given year not exceed 133% of the employee's accrual rate in any earlier year of service.[100]

[100] 26 C.F.R. § 1.411(b)-1(b)(1) through 26 C.F.R. § 1.411(b)-1(b)(3).

Practice Tip: The most natural test for cash balance plans to satisfy is one that compares one year to any prior year. Thus, cash balance plans most commonly rely on the 133 1/3 percent test. Using this test, the annual pay-related credit under a cash balance plan seldom creates backloading problems, especially since the 133 1/3 percent rule treats a plan amendment increasing benefits as if it were in effect for all prior years. Thus, a general increase in a cash balance plan's rate of benefit accrual should not affect its ability to satisfy the 133 1/3 percent test.

For plan years beginning on or after Jan. 1, 2012, a plan that determines 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 that the variable rate is zero for the current and all future plan years.[101]

[101] 26 C.F.R. § 1.411(b)-1(b)(2)(ii)(G).

.30.50 Decrease in Accrual Due to Attainment of an Age Prohibited in Cash Balance Plans —

A cash balance plan does not satisfy the minimum vesting standards of I.R.C. § 411(a) if, under the terms of the plan, participants' benefit accruals are discontinued or the rate of participants' benefit accrual is reduced because of the attainment of any age. However, a plan can place a ceiling on the maximum benefit that an individual can accrue, or limit the number of years of service that will be taken into account in computing accrued benefits.[102]

[102] I.R.C. § 411(b)(1)(H)(i).

A cash balance plan will fail to comply with the requirements of I.R.C. § 411(b)(1)(H) if, either directly or indirectly, a participant's rate of benefit accrual is reduced, including stopping plan participation or accruals, because of the participant's attainment of any age.[103] This means that an individual who is or who could be a plan participant cannot receive a lower accrual rate just because that individual is older. An indirect reduction in benefit accrual for older workers might occur when younger workers are assigned to a different division even though they do the same work as older employees, and the younger division has a higher accrual rate. Assignment to a specific division would be a proxy for being older or younger.[104] Similarly, an impermissible reduction in benefit accrual may occur if an employee's service after attainment of Social Security retirement age is disregarded for benefit accrual purposes.[105]

[103] Prop. 26 C.F.R. § 1.411(b)-2, 67 Fed. Reg. 76123 (Dec. 11, 2002).

[104] Prop. 26 C.F.R. § 1.411(b)-2, 67 Fed. Reg. 76123 (Dec. 11, 2002).

[105] Prop. 26 C.F.R. § 1.411(b)-2, 67 Fed. Reg. 76123 (Dec. 11, 2002).

.30.60 Vesting Schedules in Cash Balance Plans —

Cash balance plan participants must become fully vested in their plan benefits after no more than three years of service.[106] This three-year vesting requirement applies with respect to a participant's entire accrued benefit, even if only a portion of the participant's accrued benefit under the plan is determined under a statutory hybrid benefit formula.[107]

[106] I.R.C. § 411(a)(13)(b).

[107] 26 C.F.R. § 1.411(a)(13)-1(c)(1).

Similarly, the three-year vesting requirement also may apply to a participant's entire accrued benefit derived from the greater of two or more benefit amounts under a plan, when each amount is determined under a different benefit formula.[108] This could include a benefit determined pursuant to an offset among formulas within the plan or a benefit determined as the greater of a protected benefit under I.R.C. § 411(d)(6) and another benefit amount. If at least one of these benefits is a benefit calculated under a statutory hybrid benefit formula, the three-year vesting requirement applies to that participant's entire accrued benefit under the plan, even if the participant's benefit under the statutory hybrid benefit formula is ultimately smaller than the participant's benefit under the other formula.[109]

[108] 26 C.F.R. § 1.411(a)(13)-1(c)(1).

[109] 26 C.F.R. § 1.411(a)(13)-1(c)(1).

.30.70 Distributions From Cash Balance Plans —

Cash balance plan participants can receive benefits in annuity form or, if the plan so provides, in the form of a lump sum distribution.[110]

[110] *See* I.R.C. § 417; ERISA § 206.

Prior to the passage of the Pension Protection Act and the hybrid regulations, distributions from cash balance plans presented significant challenges for employers due to the *whipsaw effect*. The IRS previously took the position that a lump-sum distribution from a cash balance plan was not determined simply and directly by the balance of the cash balance plan account.[111] Instead, the IRS required that the cash balance plan account be projected to retirement age and converted to a retirement annuity using the interest rate and mortality assumptions specified in the plan.[112] Then, to derive the amount of the lump-sum distribution, the retirement annuity was required to be converted back to a lump sum and discounted to the participant's current age using the interest rate and mortality table specified in I.R.C. § 417.[113] If this latter interest rate was lower than the plan rate, the difference between the cash balance plan account and the lump sum value could be substantial, resulting in a distribution substantially greater than the cash balance account value (also referred to as *whipsaw* or the *whipsaw effect*).

[111] IRS Notice 96-8.

[112] IRS Notice 96-8.

[113] IRS Notice 96-8.

The PPA eliminated the *whipsaw* problem by allowing a lump-sum distribution to equal the amount in the participant's cash balance plan account so long as the plan's interest crediting rate does not exceed a market rate of return.[114]

[114] I.R.C. § 411(a)(13)(A), added by §701(b)(2) of the 2006 PPA, Pub. L. No. 109-280, and amended by Pub. L. No. 110-458, § 107(b)(2), effective as if included in the 2006 PPA.

.30.80 Minimum Required Distributions From Cash Balance Plans —

Cash balance plans also are subject to the I.R.C. minimum required distribution rules. These rules require that, for distributions during a participant's lifetime, the plan must provide that a participant's entire benefit:

- will be distributed on or before the participant's *required beginning date*; or

• will be distributed beginning no later than the participant's required beginning date, over the participant's life, the lives of the participant and a designated beneficiary or over a period that does not extend past the life expectancy of the participant (according to IRS rules) or that of the participant and his or her designated beneficiary.[115]

[115] I.R.C. § 401(a)(9).

In general, the required beginning date for a participant who is not a 5%-or-more owner is April 1 of the year following the later of the year in which the participant turns age 72 or the year in which he or she retires.[116]

[116] I.R.C. § 401(a)(9) as amended by Small Business Job Protection Act, Pub. L. No. 104-188, § 1404.

Once benefit payments must begin, they must continue every year in an amount determined under IRS rules. Failure to distribute at least the amount required under these rules in any year could jeopardize plan qualification. In all cases, it will result in the imposition of an excise tax. Special minimum required distribution rules apply where the participant dies before the benefits have been completely distributed.[117]

[117] I.R.C. § 401(a)(9).

For more, see *Required Distributions.*

.30.90 Nondiscrimination Requirements for Cash Balance Plans —

A cash balance plan must provide contributions or benefits that do not discriminate in favor of highly compensated employees (HCEs). A safe harbor test is prescribed for cash balance plans.[118] The safe harbor test requires a uniform hypothetical allocation formula and prescribes rules for interest adjustments that may be used by the plan. If the cash balance plan satisfies the safe harbor test, actual rate group testing of equivalent allocation rates or accrual rates is not required. However, a cash balance plan does not have to be designed to satisfy the safe harbor test. If a cash balance plan does not satisfy the safe harbor test, then rate group testing must be performed and the cash balance plan may test accrual rates or equivalent allocation rates.

[118] 26 C.F.R. § 1.401(a)(4)-8(c)(3).

> ***Practice Tip:*** Because younger workers often are non-highly compensated and because cash balance plans generally provide greater benefits during the early years of employment, cash balance plans should not have problems demonstrating compliance under the general nondiscrimination test.

For more, see *Nondiscrimination Rules: Testing.*

30.100 30.100 Anti-Cutback Rule's Impact on Cash Balance Plans —

The anti-cutback rule generally prohibits a qualified plan from decreasing a participant's accrued benefit by a plan amendment.[119] Because of this, an employer must use caution when amending a cash balance plan to reduce any accrued benefit or amending a traditional defined benefit plan to convert it into a cash balance plan. In the event of conversion, the cash balance plan must satisfy the special rules for plan conversion amendments set forth in the hybrid regulations.[120] For more, see *Cash Balance Plan Conversions.* In addition, the cash balance plan must preserve any optional form of benefit that applied to the previously accrued traditional defined benefit plan benefit.[121] For more on the anti-cutback relief provided to certain cash balance plan amendments made to comply with the market rate of return requirements, see *Interest Credits in Cash Balance Plans.*

[119] I.R.C. § 411(d)(6).

[120] 26 C.F.R. § 1.411(b)(5)-1(c).

[121] 26 C.F.R. § 1.411(d)-4. Q&A-1.

.30.110 Benefit Limitations in Cash Balance Plans —

Cash balance plans must meet the I.R.C. maximum limit on accrued benefits applicable to defined benefit plans. For more on the annual limits, see *Employee Benefits COLA Chart.*

.40 Funding Cash Balance Plans

.40.10 Funding Cash Balance Plans: The Basics —

A cash balance plan, as a defined benefit plan, promises to pay participants a formula-determined benefit at retirement. The plan's benefit is expressed as a hypothetical individual account balance, which grows from year to year. However, the plan's hypothetical accounts exist only as a bookkeeping device to keep track of the current value of a participant's benefit. Periodically, the employee's balance receives a credit that is generally computed as a flat percentage of the participant's pay.[122]

[122] Employee Benefits Security Administration, Fact Sheet: Cash Balance Pension Plans.

Cash balance plans tend to reduce pension costs when compared to traditional defined benefit plans because the expensive early retirement subsidies typically built into traditional defined benefit plans are not characteristic of cash balance plans. Also, cash balance plans can lower the plan's benefit targets and thus the level of contributions, because cash balance plans base benefits on current pay rather than projected final average pay.[123]

[123] 26 C.F.R. § 1.411(a)(13)-1.

Further, in contrast to defined contribution plans, the employer retains investment control over a cash balance plan's assets. Since the plan is a defined benefit plan, participants generally are not allowed to direct the investment of their theoretical account balances. Since participants receive interest credits at a stated rate, if the plan's investment performance exceeds that rate, the excess can be applied to reduce the employer's cost of funding. Conversely, if investments do not outperform the assumed interest rate, participants' hypothetical account balances still will increase at the stated rate, and the employer will have to absorb the loss. However, that loss can be absorbed gradually, on an amortized basis.[124] For more on funding, see *The Minimum Funding Standard.*

[124] TM Portfolio 352.V.B.4.: Specialized Qualified Plans—Cash Balance, Target, Age-Weighted and Hybrids, Plan Design Considerations, Allocation of Risk and Reward.

.40.20 Funding Methods for Cash Balance Plans —

Cash balance plans are funded under the same funding methods as traditional defined benefit plans; contributions are actuarially determined, taking into account expected fund earnings and forfeitures. Anticipated experience can be taken into account in advance and any gains or losses can be amortized over a period of years. Funding must be based on realistic actuarial assumptions, but this standard is sufficiently broad to allow employers considerable flexibility. Thus, a cash balance plan affords the employer greater funding flexibility than a defined contribution plan, since actuarially based funding allows the employer to choose contributions within the IRS minimum and maximum deductible contribution limits.[125]

[125] I.R.C. § 412(c)(3); ERISA § 302(c)(3).

Factors to consider in selecting the benefit formula for the annual credit (generally a flat percentage of pay) include the following:

- the amount of benefits that are available from any accompanying savings plan maintained by the employer;
- the benefit levels of the plan being replaced, if any;
- the fact that cash balance plan participants must become vested within three years;
- the cost attributable to minimum promised benefits or to grandfathered benefit amounts;
- a reduction in costs required by an employer's financial condition; and
- the employer's need to meet the benefit levels of its competitors to attract and retain top employees.[126]

[126] *See* The Pension Forum, Volume 11 – Issue 1, Society of Actuaries, October 1998.

.40.30 Minimum Funding Standard for Cash Balance Plans —

As a defined benefit plan, a cash balance plan is subject to the minimum funding standard of I.R.C. § 412 and ERISA § 302. The rules for calculating the minimum required contribution to a defined benefit plan are generally set forth in 26 C.F.R. § 1.430(a)-1. Under those regulations, the calculation depends on whether plan assets are below the plan's *funding target*. For more on defined benefit plan funding standards, see *The Minimum Funding Standard.*

Penalties for failure to meet the minimum funding standard may include the following:

- a continuing obligation to fund the plan (plus interest);
- excise taxes on the funding deficiency;
- a PBGC-enforceable lien on employer assets;
- civil damages arising from participant suits permitted under ERISA; and
- an obligation to notify participants and the PBGC or to pay a daily penalty for the failure to do so.[127]

[127] ERISA § 101(d).

.40.40 Funding Waivers for Certain Cash Balance Plans —

One technique that an employer may use if it does not have adequate funds to make its required contribution is to obtain a waiver of the minimum funding standard from the IRS.[128] The IRS may waive the standard for a year in which the employer incurs a *substantial business hardship*.[129] An employer is eligible for this waiver if it is unable to satisfy the minimum funding standard for the year without substantial business hardship, and if applying the standard would be adverse to the interests of plan participants in the aggregate.[130]

[128] I.R.C. § 412(c)(1)(A).
[129] I.R.C. § 412(c)(1)(A).
[130] I.R.C. § 412(c)(1)(A).

A substantial business hardship does not waive any required minimum contribution.[131] Instead, if the waiver is granted, the minimum required contribution under I.R.C. § 430 is re-amortized over a five-year period beginning with the succeeding plan year.[132]

[131] I.R.C. § 412(c)(1)(B); I.R.C. § 430(e).

[132] I.R.C. § 412(c)(1)(B); I.R.C. § 430(e).

.50 Cash Balance Plan Conversions

.50.10 Cash Balance Plan Conversions Basics —

A defined benefit plan can be converted to a cash balance plan through plan amendment, rather than by termination. The hybrid regulations provide guidance on cash balance plan conversions.[133] For more, see *IRS Guidance on Cash Balance Plan Conversions.*

[133] 26 C.F.R. § 1.411(a)(13)-1 and 26 C.F.R § 1.411(b)(5)-1.

PPA § 701 amended ERISA § 204(b), which imposes restrictions on converting a traditional defined benefit plan into a cash balance plan. Under the amended provision, if a plan amendment converting the plan is adopted after June 29, 2005, the plan is age discriminatory unless each participant's benefit after the conversion equals the sum of the participant's accrued benefit for years of service before the effective date of the amendment (determined under plan terms as in effect before the amendment) and the participant's accrued benefit for years of service after the effective date of the amendment (determined under plan terms as in effect after the amendment).[134] In addition, for purposes of calculating the participant's accrued benefit for years of service before the effective date of the amendment, a plan must include the value of any early retirement benefit or subsidy for the plan year in which the participant retires if, as of such time, the participant has met the age, years of service and other plan requirements for entitlement to such benefit or subsidy.[135]

[134] ERISA § 204(b)(5)(B)(iii), as amended by the Pension Protection Act of 2006, Pub. L. No. 109-280, § 701.

[135] ERISA § 204(b)(5)(B)(iv).

In connection with the enactment of PPA § 701, the IRS issued Notice 2007-6, which provided interim guidance on PPA provisions involving cash balance plans. For more, see *IRS Guidance on Cash Balance Plan Conversions.*

.50.20 Steps for Converting a Traditional Defined Benefit Plan to a Cash Balance Plan —

In general, for an employer to convert a traditional defined benefit plan into a cash balance plan, it must:

- adopt an amendment to an existing defined benefit plan amending and restating it in the form of a cash balance plan;
- calculate the benefit already accrued under the traditional defined benefit plan for each participant;
- establish a means of indexing the initial account balances so that initial account balances increase annually pursuant to percentage of salary increases and guaranteed interest rate increases;
- base annual benefit accruals on current pay rather than final average pay; and
- consider transition and protected benefits to preserve the benefits that would have been provided under the

prior benefit formula.[136]

[136] IRS Notice 2006-7.

.50.30 Grandfathering and Transition Credits in Cash Balance Plan Conversions —

Because cash balance plans are subject to the I.R.C. requirements for defined benefit plans generally, they must comply with the I.R.C. requirements regarding protected benefits and the anti-cutback rule.[137] Therefore, employers will often need to *grandfather* protected benefits from the traditional defined benefit plan when converting to a cash balance plan. One option would be for the cash balance plan to incorporate the former plan's formula (including early retirement subsidies) as a minimum benefit, so that I.R.C. § 411(d)(6) can never be violated.

[137] I.R.C. § 411(d)(6).

.50.40 Cash Balance Plan Conversion Problems —

Various problems can arise when an employer converts a traditional defined benefit plan into a cash balance plan. Two of the most common are:

• Younger participants with a significant amount of service may find that the value of their accruals is surprisingly low, even though they have worked for the company for a number of years.

• Older participants approaching retirement may find that the conversion reduces their projected retirement benefits, because they will, in the future, receive the same benefit accruals as younger participants and miss out on traditional benefit increases with age, while at the same time not participating long enough to experience the full effects of the benefit increases associated with the compounding of interest.

For more, see TM Portfolio 352 V.B.: Plan Design Considerations.

Practice Tip: There are several solutions to these types of problems that can ease the process of converting a traditional defined benefit plan into a cash balance plan. For example, an employer converting a traditional defined benefit plan to a cash balance plan could:

• apply a higher interest crediting rate to the initial balance of a participant's account;

• use a dynamic grandfathering provision, so that for participants in the prior plan the benefit will not be less than the benefit the participant would receive if the prior plan still existed, essentially creating a floor plan to offer this benefit (this approach generally uses the pre-existing traditional defined benefit plan's formula as the basis for the minimum benefit);

• provide a minimum initial account balance equal to the account balance the participant would have had if the traditional defined benefit plan had always been a cash balance plan;

• provide for additional future service benefit credits for older and/or longer service employees; and/or

• use “conservative” actuarial assumptions to enable participants nearing retirement to receive larger annuities than those to which they were entitled at the time of the transition.

For more, see TM Portfolio 352 V.B.: Plan Design Considerations.

.50.50 IRS Guidance on Cash Balance Plan Conversions —

The hybrid regulations provide special rules for plan conversion amendments.[138]

[138] 26 C.F.R. § 1.411(b)(5)-1(c).

No Wear Away A participant whose benefits are affected by a conversion amendment that was both adopted and effective on or after June 29, 2005 must generally be provided with a benefit after the conversion that is at least equal to the sum of the benefits accrued through the date of the conversion, determined under plan terms in effect immediately before the effective date of the conversation amendment, and benefits accrued after the conversion, determined under plan terms as in effect after the effective date of the conversation amendment, with no permitted interaction between these two portions. This assures participants that there will be no *wear-away* as a result of a conversion, both with respect to the participant's accrued benefits and any early retirement subsidy to which the participant may have been entitled based on the pre-conversion benefits.[139]

[139] 26 C.F.R. § 1.411(b)(5)-1(c)(2).

Establishment of Opening Account Balance. An alternative mechanism to the no wear-away rule is available under which a plan can provide for the establishment of an opening hypothetical account balance as part of the conversion if the plan keeps separate track of (1) the benefit attributable to the opening hypothetical account balance (including interest credits attributable thereto) and (2) the benefit attributable to post-conversion service under the post-conversion benefit formula.[140]

[140] 26 C.F.R. § 1.411(b)(5)-1(c)(3).

Under this alternative, when a participant commences benefits, it must be determined whether the benefit attributable to the opening hypothetical account that is payable in the particular optional form of benefit selected is greater than or equal to the benefit accrued under the plan prior to the date of conversion payable in the same generalized optional form of benefit at the same annuity starting date. If the benefit attributable to the opening hypothetical account balance is greater, then the plan must provide that such benefit is paid in lieu of the pre-conversion benefit, in addition to the benefit attributable to post-conversion service under the post-conversion benefit formula. If the benefit attributable to the opening hypothetical account balance is less, then the plan must provide that such benefit will be increased sufficiently to provide the pre-conversion benefit, in addition to the benefit attributable to post-conversion service under the post-conversion benefit formula.[141]

[141] 26 C.F.R. § 1.411(b)(5)-1(c)(3).

Although it cannot be relied upon by other employers, the IRS issued a Private Letter Ruling that sheds more light on changes to a plan design following a cash balance plan conversion. The Private Letter Ruling provides that following the conversion of a defined benefit plan to a cash balance plan intended to be a statutory hybrid plan under I.R.C. § 411(a)(13), the plan sponsor could amend the plan so that an interest rate lookback month of September is used for all present value determinations for all participants, including as to protected benefits for all participants whose cash balance effective date was the plan conversion date. Present value determinations prior to the conversion were based on interest rates for the lookback month that is the first full calendar month preceding the plan year in which the annuity starting date occurs. The plan sponsor sought the amendment to simplify plan administration and enable the plan to provide benefit distribution paperwork more timely for January 1 annuity starting dates. The Private Letter Ruling provides that the amendment would not cause the plan to violate § 411(b)(5)(B)(ii) or § 411(b)(5)(B)(iii), which prohibit benefit wear-away as a result of the conversion.[142]

[142] PLR 201803006.

For more on accrued benefit formulas, see *Accrual Rules.*

.50.60 Communicating During Cash Balance Plan Conversions —

Communicating cash balance plan conversions to participants is critical for a smooth transition. The issue of disclosure—how far employers should go to make sure participants are informed about plan conversions—is a contentious topic in conversions regarding participant disclosures. Everyone involved in the conversion wants participants to understand the plans and conversion. However, due to the complexities of defined benefit plans, employers and regulators have difficulty determining at what point the information becomes overwhelming and incomprehensible to the average plan participant.

Notice Requirements in ERISA and the Code. Both the I.R.C. and ERISA include provisions intended to ensure that participants receive *meaningful disclosure* for amendments that result in a reduction in benefits, especially cash balance plans.

I.R.C. § 4980F imposes an excise tax on the failure to provide notice of a plan amendment that significantly reduces the rate of future benefit accrual or eliminates an early retirement benefit or retirement-type subsidy to each affected participant.[143] The notice must be written in a manner calculated to be understood by the average plan participant and must provide sufficient information for participants to understand the effect of the plan amendment.[144]

[143] I.R.C. § 4980F(a).
[144] I.R.C. § 4980F(e).

ERISA § 204(h) has most of the same language as I.R.C. § 4980F, excluding the implementation of the tax. Section 204(h) includes an "egregious failure provision," which states that, in the case of any egregious failure to provide the required notice, affected participants will be entitled to the greater of the benefit before the amendment or the benefit due under the amendment.[145]

[145] ERISA § 204(h)(6).

Use SmartCode® for the latest cases on cash balance conversions and ERISA § 204(h) requirements.

Treasury regulations explain the required timing and content for the notice, how notice must be provided, upon which events and to whom the notice must be provided and the penalty for violation.[146] With respect to the required timing for the notice, notice must be provided at least 45 days before the effective date of the plan amendment, though most small plans and business mergers and acquisitions would have a 15-day notice requirement.[147]

[146] 26 C.F.R. § 54.4980F-1.
[147] 26 C.F.R. § 54.4980F-1, Q&A-9(a); Q&A-9(b); Q&A-9(d)(1).

The notice must include sufficient information to allow recipients to understand the effect and magnitude of the plan amendment, including:

- a description of the benefit or allocation formula prior to the amendment;
- a description of the plan's benefit or allocation formula as amended;
- the effective date of the amendment;[148] and

- sufficient information for each participant to understand the approximate magnitude of the expected reduction for that participant.[149]

[148] 26 C.F.R. § 54.4980F-1, Q&A-11.

[149] 26 C.F.R. § 54.4980F-1, Q&A-11.

If the approximate magnitude of the reduction for each participant is not reasonably apparent from the description of the amendment, further information is required through illustrative examples or further narrative text, as described in the regulations.[150] The notice cannot include:

[150] 26 C.F.R. § 54.4980F-1, Q&A-11.

- materially false or misleading information; or

- an omission that causes the information provided to be misleading.[151]

[151] 26 C.F.R. § 54.4980F-1, Q&A-11.

In addition, if an amendment by its terms impacts different classes of participants differently, then the applicable requirements must be satisfied for each class of participants.[152] The notice can provide more information than required. However it cannot be detailed to the point that it is too complicated for recipients to understand, which defeats the purpose of providing notice.[153]

[152] 26 C.F.R. § 54.4980F-1, Q&A-11.

[153] 26 C.F.R. § 54.4980F-1, Q&A-11.

Notice must be provided through a method that results in actual receipt of the notice, or the plan administrator must take appropriate and necessary measures reasonably calculated to ensure that the method for providing the notice results in actual receipt.[154] First class mail and hand delivery are both acceptable distribution methods.[155] In addition, employers can use electronic means to furnish the notice, but only if the applicable regulatory requirements are met.[156] Posting of the notice is not sufficient.[157]

[154] 26 C.F.R. § 54.4980F-1, Q&A-13.

[155] 26 C.F.R. § 54.4980F-1, Q&A-13.

[156] 26 C.F.R. § 54.4980F-1, Q&A-13.

[157] 26 C.F.R. § 54.4980F-1, Q&A-13.

Employers only have to provide notice for amendments that provide for a significant reduction in the rate of future benefit accrual or that provide for the significant reduction of an early retirement benefit or retirement-type subsidy.[158] A reduction in the rate of future benefit accrual for a defined benefit plan occurs only if it is reasonably expected that the amendment will reduce the amount of the future annual benefit commencing at normal retirement age, or at actual retirement age, if later, for benefits accruing for a year.[159]

[158] 26 C.F.R. § 54.4980F-1, Q&A-5.

[159] 26 C.F.R. § 54.4980F-1, Q&A-6(b).

The notice must be provided to each applicable individual and to each employee organization representing participants who are applicable individuals.[160] An applicable individual includes each participant in the plan and any alternate payee whose rate of future benefit accrual or early retirement benefit or retirement-type subsidy under the plan can reasonably be expected to be significantly reduced.[161] An alternate payee is someone designated to receive benefits under a qualified domestic relations order.[162]

[160] 26 C.F.R. § 54.4980F-1, Q&A-10.
[161] 26 C.F.R. § 54.4980F-1, Q&A-10.
[162] 26 C.F.R. § 54.4980F-1, Q&A-10.

Penalties for Failure to Provide Notice. The penalties for violating I.R.C. § 4980F and ERISA § 204(h) differ. The sanction for failure to provide notice under ERISA § 204(h) turns on whether the failure is egregious. An egregious failure occurs if the failure is within the control of the employer and is either an intentional failure or a failure, whether or not intentional, to provide most of the individuals with most of the information they are entitled to receive.[163] It is not egregious if the employer was reasonable in the determination that the amendment did not constitute a significant reduction in the future benefit accrual rate or early retirement benefit or retirement-type subsidy. If a violation is egregious, all applicable individuals receive the greater of the benefit with or without the amendment.[164]

[163] ERISA § 204(h).
[164] ERISA § 204(h); 26 C.F.R. § 54.4980F-1, Q&A-14(a).

The penalty for a violation of I.R.C. § 4980F is the imposition of an excise tax on the employer or, in the case of a Collectively Bargained Multiemployer Pension Plan, the plan is responsible for the excise tax. The amount of the excise tax is $100 per day, per applicable individual who did not receive notice, beginning when the failure occurs and ending when the failure is remedied.[165] The excise tax will not be applied if:

[165] I.R.C. § 4980F(b).

- the employer exercised reasonable diligence but did not know that the failure existed; or
- the employer corrects the problem within 30 days of the first date the employer knew, or exercising reasonable diligence would have known, that such failure existed.[166]

[166] I.R.C. § 4980F(c)(1); I.R.C. § 4980F(c)(2).

Aids to Understanding Conversion. Employers have a few options available to them to help participants understand a cash balance conversion. One such option is computer modeling, which can help participants understand how the amendment is going to affect their individual benefits.

Practice Tip: Computer modeling allows participants to input their personal information, and the computer program is then able to calculate their benefit under the new formula and the old. Participants also can figure in reasonable assumptions, such as pay increases and length of service, to arrive at their projected benefits. The benefit calculated by the computer model is not an absolute guarantee that the participant will receive the specified amount; it could be more or less depending on certain variables that cannot be taken into account by any calculation. Many benefits consulting firms have already developed a computer program for the modeling that can be adjusted for individual employers.

Practice Tip: If an employer does not want to provide computer modeling, or it would not be particularly useful because many participants do not have access to a computer, another alternative would be to provide individual calculations that can be sent to each participant. These calculations can help participants understand how the amendment is going to affect their benefits, even if they do not understand the amendment itself.

Tenth Circuit Case Regarding Conversion Communications. Solvay Chemicals Inc. did not violate ERISA's notice requirements when it used tables to demonstrate how its conversion from a traditional defined benefit plan to a cash balance plan would impact participants' pension benefits, the U.S. Court of Appeals for the Tenth Circuit ruled.[167]

[167] *Jensen v. Solvay Chemicals Inc.*, 625 F.3d 641, 49 EBC 2415, (10th Cir. 2010).

ERISA § 204(h) regulations did not require Solvay to describe to its participants, in either specific percentage or dollar terms, that the plan conversion would result in a reduction in their future accrual rates. Instead, Solvay's use of tables drawing comparisons of hypothetical benefit numbers met the notice requirements of ERISA § 204(h) with respect to normal retirement benefits because participants could look to tables and estimate their benefit reductions in dollar terms.[168]

[168] *Jensen v. Solvay Chemicals Inc.*, 625 F.3d 641, 49 EBC 2415, (10th Cir. 2010).

Solvay's cash balance plan also did not violate the Age Discrimination in Employment Act, and Solvay complied with a number of other ERISA notice and disclosure requirements. However, the Tenth Circuit remanded the issue of whether the participants were entitled to any relief for Solvay's failure to give them notice as to how their early retirement benefits would be affected by the plan conversion. Although the court found that the notice came up short of ERISA's requirements with respect to the description of early retirement benefits, the plaintiffs were only entitled to relief if the shortcoming by Solvay was *egregious* as required by ERISA § 204(h)(6)(A).[169]

[169] *Jensen v. Solvay Chemicals Inc.*, 625 F.3d 641, 49 EBC 2415, (10th Cir. 2010).

.60 Litigation Challenges to Cash Balance Plans

.60.10 Litigation Challenges to Cash Balance Plans Basics —

Because cash balance plans include *frontloaded* benefit formulas instead of the *backloaded* benefit formulas that are characteristic of traditional defined benefit plans, younger employees with less service can accumulate benefits faster under a cash balance plan than under a traditional defined benefit plan. Conversely, a conversion to a cash balance plan could result in older employees who have worked many years losing a substantial portion of the benefits they expected to receive under their prior traditional defined benefit pension plan.

As a result, when traditional defined benefit plans are converted to cash balance plans, the formulas for computing participants' retirement benefits change, causing some participants to claim injury. Such claims invariably focus on the fact or perception that benefits have been lost or reduced due to the participants' age.

.60.20 Age Discrimination Challenges to Cash Balance Plans —

Cash balance plans have been attacked for allegedly violating age discrimination rules under ERISA, the I.R.C. and the ADEA.

However, a plan does not violate the age discrimination provisions under ERISA, the I.R.C., or the ADEA if, under the terms of the plan, a participant's accrued benefit is equal to or greater than that of a similarly situated younger person.[170] In addition, the PPA provides that in determining whether a plan discriminates on the basis of age, the accrued benefit may be expressed in ways other than as an annuity payable at normal retirement age; for example, by using the balance of a hypothetical account.[171]

[170] ERISA § 204(b), as amended by Pension Protection Act of 2006, Pub. L. No. 109-280, § 701.

[171] ERISA § 204(b)(5)(B)(ii).

The primary argument asserted in claiming that cash balance plans inherently violate age discrimination laws is that such plans cause a decline in the rate of benefit accrual. Cash balance plan participants accrue benefits that are based on hypothetical contributions plus future interest credits that are the same for all participants regardless of age. As a result, the argument goes, the contribution results in a smaller benefit as the participant gets older because, as a participant gets older, each year's contribution will have one year less to earn interest credits before normal retirement age, producing a smaller sum at normal retirement age and a smaller annuity benefit.

In addition, converting a traditional defined benefit plan to a cash balance plan can have a *wear-away* effect if the converted balance is less than the accrued benefit under the traditional defined benefit plan. Accruals under the cash balance plan remain frozen until the value of the participant's hypothetical account exceeds the value of benefits accrued under the traditional defined benefit plan formula. Plaintiffs argue that this is discriminatory because older workers usually have the highest opening balances and are therefore are most likely to suffer the harm caused by wear-away.

The PPA addressed this issue by establishing the requirements that employers adopting cash balance plan conversion amendments after June 29, 2005, must satisfy to avoid age discrimination.[172] However, federal court decisions around and since enactment of the PPA show there is still disagreement as to whether cash balance plans are age discriminatory.

[172] ERISA § 204(b)(5)(B)(iii), as amended by the Pension Protection Act of 2006, Pub. L. No. 109-280, § 701.

Cases Finding No Age Discrimination. *Cooper v. IBM Personal Pension Plan:* IBM's cash balance plan did not discriminate against older workers in violation of ERISA, the U.S. Court of Appeals for the Seventh Circuit ruled.[173] Most courts finding that cash balance plans are not age-discriminatory cite to this case.

[173] *Cooper v. IBM Pers. Pension Plan*, 457 F.3d 636, 38 EBC 1801 (7th Cir. 2006), *cert. denied*, 127 S.Ct. 1143 (2007).

The terms of IBM's cash balance plan were age-neutral, and thus did not violate ERISA's age discrimination prohibition. ERISA's age discrimination rule for defined benefit plans, such as cash balance plans, should be treated the same as ERISA's similar rule for defined contribution plans.

The IBM employees who brought the lawsuit failed to recognize the *time value of money*. While younger employees had more time to accrue interest under the plan, this did not mean the plan discriminated against older workers.[174]

[174] *Cooper v. IBM Pers. Pension Plan*, 457 F.3d 636, 38 EBC 1801 (7th Cir. 2006), *cert. denied*, 127 S.Ct. 1143 (2007).

Register v. PNC Financial Services Group Inc.: PNC Financial Services Group Inc.'s cash balance plan did not violate ERISA's age discrimination provisions because the amount the company credited to each participant's hypothetical account was the same regardless of age, the U.S. Court of Appeals for the Third Circuit ruled.[175]

[175] *Register v. PNC Fin. Sers. Grp. Inc.*, 477 F.3d 56, 39 EBC 2409 (3d Cir. 2007).

PNC did not reduce contributions for older employees when it converted its traditional defined benefit plan to a cash balance plan. Instead, the company provided interest credits to all employees, regardless of age, and those interest credits were provided in an age-neutral fashion.

Drutis v. Rand: Cash balance pension plans do not discriminate against older workers in violation of ERISA, the U.S. Court of Appeals for the Sixth Circuit ruled, relying extensively on the reasoning in Cooper and PNC Financial Services Group Inc.[176]

[176] *Drutis v. Rand McNally & Co.*, 499 F.3d 608, 41 EBC 1577 (6th Cir. 2007), *cert denied 44 EBC 3016* (2008).

In so finding, the court rejected claims by four former employees who claimed that their employer's cash balance pension plan violated ERISA's anti-discrimination provision. Any disparity in benefits that employees of different ages received under the cash balance plan was “merely the result of the time value of money.” “We agree that the term ‘benefit accrual’ as used in [§ 204(b)(1)(H)(i)] refers to the employer's contributions to the defined benefit plan. Accordingly, because under the World Color Plan, as with cash benefit plans generally, ‘[n]either the contribution rate nor the interest rate change[d] with age,’ plaintiffs have failed to show that the World Color Plan was age discriminatory,” the Sixth Circuit said.[177]

[177] *Drutis v. Rand McNally & Co.*, 499 F.3d 608, 41 EBC 1577 (6th Cir. 2007), *cert denied 44 EBC 3016* (2008).

Walker v. Monsanto Co. Pension Plan: Monsanto Co.'s cash balance pension plan did not violate ERISA's anti-age discrimination provision by ceasing *interest credits* once plan participants reached age 55, the Seventh Circuit held.[178] The interest credits were not *benefit accruals* and therefore were not protected by ERISA's anti-discrimination provision.

[178] *Walker v. Monsanto Co. Pension Plan*, 614 F.3d 415, 49 EBC 1906 (7th Cir. 2010).

The Seventh Circuit, in other cash balance plan rulings, had not adopted a bright-line rule that any credit to a participant's cash balance account amounted to a *benefit accrual*. Not all cash balance plans are alike. Rather, Monsanto's cash balance plan was designed to mimic a defined benefit plan.

“Participants are promised a certain benefit at retirement, which is described as a lump-sum cash balance. Because this is not an ‘eligible cash balance plan’ [as described in Treasury regulations], the general mechanism for determining benefit accrual applies—'the increase in the participant's accrued normal retirement for the benefit year’,” the court said.

The interest credits at issue in this case were not benefit accruals if examined by looking at the rate of increase in participants’ accrued normal retirement benefit. “This is because [the interest credits] never increase the accrued benefit at retirement”, the court said.

Hirt v. Equitable Retirement Plan for Employees, Managers and Agents: Cash balance plans do not discriminate against older workers in violation of ERISA, the U.S. Court of Appeals for the Second Circuit ruled. The appeals court rejected the participants’ contention that ERISA measures *accrued benefit* by reference to the ultimate retirement-age annuity, and the same test should apply when considering ERISA § 204(b)(1)(H)(i)’s reference to “benefit accrual.” Congress “did not use the term ‘accrued benefit’ when it drafted ERISA § 204(b)(1)(H)(i); rather, Congress used the term 'rate of benefit accrual'", the court said. Moreover, the appeals court noted that ERISA § 204(b)(1)(H)(i) prohibits age-based reductions in the "rate" of benefit accrual. "[R]ate carries with it a temporal limitation: One cannot evaluate a rate of accrual without controlling for the passage of time. Thus, the fact that the ultimate benefit might grow to be larger for younger employees—who have more time until normal retirement age than their older counterparts—would not be relevant to the comparison of accrual rates," the appeals court said.[179]

[179] *Hirt v. Equitable Ret. Plan for Emps, Managers and Agents*, 533 F.3d 102, 44 EBC 1289 (2d Cir. 2008).

.60.30 Litigation Regarding Lump-Sum Distributions from Cash Balance Plans —

Lump-sum distributions from cash balance plans have been a significant area of litigation, with employers operating cash balance plans often seeking to limit the plans' payment liability to the amount that has amassed in a participant's hypothetical individual account. For defined benefit plans under ERISA and the I.R.C., however, the IRS historically took the position that a lump-sum benefit for a participant leaving employment before retirement was calculated by projecting the participant's hypothetical individual account to normal retirement age, converting it to an actuarially equivalent annuity using the interest rate and mortality assumptions specified in the plan and converting the annuity back to a lump sum discounted to the participant's current age using the interest rate and mortality table specified in I.R.C. § 417 (i.e., the *whipsaw* effect).

The PPA eliminates the whipsaw problem by allowing cash balance plans to pay participants' cash balance accounts in the form of a lump-sum distribution, so long as the specified interest crediting rate does not exceed a market rate of return.[180]

[180] I.R.C. § 411(a)(13)(A), added by §701(b)(2) of the 2006 PPA, Pub. L. No. 109-280, and amended by Pub. L. No. 110-458, § 701(d)(2), effective as if included in the 2006 PPA.

Whether the participant or employer has historically prevailed in the litigation often turned on how the plan defined "normal retirement age," a term ERISA § 3(24) defines as the earlier of the time a plan participant attains normal retirement age under the plan, or the later of the time a plan participant attains age 65 or reaches five years of participation in the plan.

Fry v. Exelon Corp.: Exelon Corp. did not violate ERISA by using years of service, rather than a specific age, to define the term "normal retirement age" in its cash balance pension plan, the Seventh Circuit ruled.[181]

[181] *Fry v. Exelon Corp. Cash Balance Pension Plan*, 571 F.3d 644, 47 EBC 1193 (7th Cir. 2009), cert. denied, 130 S. Ct 1504, *48 EBC 2952* (2010).

The three-judge appellate panel, in affirming the district court, agreed with Exelon that ERISA allows pension plan sponsors to define "normal retirement age" as they please. The court thus found no ERISA violation in Exelon's decision to define "normal retirement age" as "five years of vesting service," rather than a specific age. "ERISA does not require the 'normal retirement age' to be the same for every employee," the court said.

Example: The plaintiff, William Fry, left his employment with Exelon prior to age 65. At the time he left the company, Fry had five years of vesting service under the company's cash balance plan. In calculating Fry's lump-sum distribution under the plan, Exelon did not include a *whipsaw calculation* because he had reached "normal retirement age" as defined by the plan. Fry argued that because he was not yet age 65, his benefits should have been computed using a whipsaw calculation.

In his lawsuit, Fry argued that Exelon's plan violated ERISA because "normal retirement age" under ERISA can only be a specified age and not a specified term of service. Fry asserted that, because the plan did not specify an age, the default age of 65 was deemed to be the normal retirement age for purposes of applying provisions of ERISA. Exelon argued, on the other hand, that nothing in ERISA prohibits plans from using service time as a measurement for normal retirement age.

The Seventh Circuit noted that the PPA now allows cash balance plans to make distributions at any time based on participants' account balances without performing a whipsaw calculation. The PPA was enacted after Fry received his distribution from Exelon's plan, and thus was inapplicable, the court said. Regardless, the Seventh Circuit held that a whipsaw calculation was not required because Fry had reached his normal retirement age, as defined under the plan.

McCorkle v. Bank of Am. Corp. and Pender v. Bank of Am. Corp.: Based on the Fry Standard, the U.S. Court of Appeals for the Fourth Circuit affirmed the dismissal of backloading claims against Bank of America Corp. The cash balance plan's defining normal retirement age as the earlier of the date the participant completes five years of service or the date the participant attains age 65 complies with ERISA, since IRS guidance has long recognized that a retirement plan may specify a normal retirement age that is below age 65.[182] In addition, the Fourth Circuit determined that the plan's definition of normal retirement age did not violate anti-backloading rules because backloading under the plan only occurred after a participant reached normal retirement age, and ERISA's anti-backloading rules do not apply once a plan participant reaches normal retirement age.[183]

[182] *McCorkle v. Bank of America Corp.*, 688 F.3d 165, 53 EBC 2701 (4th Cir. 2012), cert. denied, *54 EBC 2921* (2013).

[183] *McCorkle v. Bank of America Corp.*, 688 F.3d 165, 53 EBC 2701 (4th Cir. 2012), cert. denied, *54 EBC 2921* (2013).

However, the participants could proceed with their ERISA claim challenging the $3 billion transfer from Bank of America Corp's 401(k) plan to its cash balance plan that lacked a *separate account* feature. The participants had standing under ERISA to seek equitable relief for a violation of ERISA's anti-cutback rule, which prohibits plan amendments that reduce accrued benefits. The participants' requested relief—the difference between the money Bank of America made from their plan investments and the amount of money they were actually credited with—is a permissible equitable remedy under ERISA.[184] Ultimately, the Fourth Circuit affirmed the dismissal of the participants' ERISA claims and agreed with Bank of America that it did not profit from the transfers because the pension plan's investment strategy had performed more poorly than the participants' investments strategies, as demonstrated by their 401(k) account investment allocations.[185]

[184] *Pender v. Bank of Am. Corp.*, 788 F.3d 354, 59 EBC 2585 (4th Cir. 2015).

[185] *Pender v. Bank of Am. Corp.*,]736 Fed. Appx. 359, 2018 EBC 197862 (unpublished) (4th Cir. 2018).

Laurent v. PricewaterhouseCoopers LLP: PricewaterhouseCoopers LLP's cash balance plan violated ERISA by designating "five years of vesting service" as the plan's normal retirement age, because the phrase "five years of service" bore no plausible relation to "normal retirement," the Second Circuit held.

ERISA provides retirement plan creators with considerable discretion to determine the normal retirement age, the appellate court said, but that discretion isn't boundless. Plan creators have discretion to decide what age is reasonable for their workers to retire, which may be 65 for office workers or 35 for shortstops. However, the plain meaning of the statute does not permit an ordinary financial services company to select age 35 as its normal retirement age.

ERISA expressly provides that the time selected must be "the time a plan participant attains normal retirement age under the plan." The problem with the plan's definition in this case is not that it is not based on age, but rather that it bears no relationship to the normal retirement age for its industry. If the plan defined the normal retirement age as 30 years of service, it would have been difficult for the employees to argue that the normal retirement age was not a time that a plan participant attains normal retirement age.[186]

[186] *Laurent v. PricewaterhouseCoopers LLP*, 794 F.3d 272, 53 EBC 2701 (2d. Cir.), cert. denied, 136 S. Ct. 981 (2016).

West v. AK Steel Corp. Retirement Accumulation Pension Plan: A cash balance pension plan sponsor illegally forfeited plan participants' benefits when it failed to use a whipsaw calculation in computing the lump-sum distributions of participants who retired or terminated their employment prior to reaching age 65, the Sixth Circuit ruled.[187]

[187] *West v. AK Steel Corp. Retirement Accumulation Pension Plan*, 484 F.3d 395, 40 EBC 1769 (6th Cir. 2007).

There also was no merit to the employer's contention that it was not required under ERISA and IRS regulations to employ a whipsaw calculation when calculating lump-sum distributions. The ruling kept intact the lower court's award of over $46 million in benefits and prejudgment interest to the 1,250 former workers who received lump-sum distributions prior to the age of 65.

The PPA amended ERISA and the Code to explicitly state that cash balance plans are not required to employ whipsaw calculations when figuring lump-sum distributions. The PPA's amendments to ERISA, however, only apply to distributions made after Aug. 17, 2006, and the distributions at issue were all made between January 1995 and April 2005, before the passage of the PPA.

There also was no merit to the employer's contention that calculating lump-sum payments using a whipsaw calculation would lead to age discrimination. "[W]hat may appear at first blush to be age discrimination is really nothing more than the time value of money," the Sixth Circuit said, citing *Cooper v. IBM Pension Plan*, where the Seventh Circuit found that a cash balance plan did not discriminate against older workers.

Berger v. Xerox Retirement Income Guarantee Plan: Employers were required to calculate the participants' accrued benefits as an annuity at normal retirement age and determine the present value of the amount under the provisions governing defined benefit plans and mandated in IRS Notice 96-8, rather than paying an individual account balance, the Seventh Circuit ruled.[188] Xerox violated ERISA when it calculated cash balance plan lump-sum distributions for employees who left the company before reaching age 65 without including interest credits that would have accumulated by the time the participants reached age 65.

[188] *Berger v. Xerox Corp. Retirement Income Guarantee Plan*, 338 F.3d 755, 30 EBC 2505 (7th Cir. 2003).

Under a conversion from a defined benefit plan into a cash balance plan, Xerox made allocations to each participant's hypothetical account in the form of a *compensation credit* equal to 5% of the participant's compensation and an *interest credit*. The interest credit was defined by the plan as the average one-year Treasury bill rate for the prior year plus 1%.

Employees who left Xerox before reaching age 65 and opted to receive their cash balance plan balances in a lump-sum distribution received those distributions with future interest credits excluded from the amount. Those electing the lump sum sold “their pension entitlement back to the company cheap, and that is a sale that ERISA prohibits.”

By not including future interest credits in lump-sum distributions, Xerox failed to ensure that its cash balance plan was *frontloaded* as required by IRS Notice 96-8. Frontloading requires that participants receive interest on the money in their hypothetical plan accounts for the period between the time they leave the company and the time they reach age 65.

Xerox Court in Agreement With Other Circuits: The finding of the Seventh Circuit in *Xerox* was consistent with findings by the U.S. Court of Appeals for the Eleventh Circuit and Second Circuit addressing the issue of calculation of lump sums in cash balance plans.

The Bank of Boston's retirement plan violated ERISA and the I.R.C. when it calculated a cash balance plan participant's lump-sum distribution using an interest rate lower than the minimum interest credit guaranteed by the plan, the Second Circuit ruled. The calculation was faulty because when the projected amount was discounted back to present value, the participant received less than the actuarial equivalent of her normal retirement benefits in violation of ERISA.[189]

[189] *Esden v. Bank of Boston*, 229 F.3d 154, 24 EBC 2761 (2d Cir. 2000).

The Bank of Boston's cash balance plan was designed to ensure that, when a participant opted for a lump-sum distribution, the participant would always receive his or her current cash balance account. To accomplish this, the plan was drafted so that a participant's normal retirement benefit was always projected at a rate of 4%, even though the plan provided that interest credits could not accrue at a rate lower than 5.5%. By projecting the participant's cash balance plan account forward at a rate less than the minimum 5.5% interest credit provided under the plan, the participant received less than the actuarial equivalent of her accrued benefit in violation of ERISA § 203(e)(3). In addition, because the participant received less than she would have had she not elected a lump sum-distribution, part of her cash balance plan benefit was conditioned on the option chosen, which violated the anti-forfeiture provisions of ERISA § 203(a).

An employer violated § 203(e) of ERISA when it failed to discount to present value a cash balance plan participant's lump-sum distribution, the Eleventh Circuit ruled. 26 C.F.R. § 1.411(a)-11 controlled the calculation of consensual lump-sum payouts under the cash balance plan for distributions that occurred before the effective date of the Retirement Protection Act of 1994, including the plaintiff's lump-sum distribution, which occurred in 1993. The regulation in effect at that time required that lump-sum distributions under the plan be calculated by determining what would have been the normal retirement benefit had the participant not elected to take an early lump-sum distribution, and then discounting that amount of present value using the PBGC rate prescribed in § 203(e).[190]

[190] *Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan*, 221 F.3d 1235, 24 EBC 2473 (11th Cir. 2000); *cert. denied*, 532 U.S. 967 (2001).

.60.40 Litigation Regarding Accrual Issues in Cash Balance Plans —

U.S. Bancorp's cash balance pension plan did not violate ERISA when it used an 8% discount rate to compute plan participants’ opening balances, the Eighth Circuit ruled.[191]

[191] *Sunder v. U.S. Bancorp Pension Plan*, 586 F.3d 593, 47 EBC 2862 (8th Cir. 2009).

Nothing in ERISA prohibited U.S. Bancorp from using the 8% rate, which was at the time higher than the statutory 30-year Treasury rate of just over 6%.

The rate used by U.S. Bancorp was significant for plan participants because the higher the interest rate used, the lower the participants' opening account balances would be when U.S. Bancorp converted from a traditional defined benefit plan to a cash balance plan.

While I.R.C. § 417(e)(3) requires that cash balance plans use a statutorily prescribed rate when calculating plan participants' lump-sum distributions, I.R.C. § 417(e)(3) does not speak to the interest rates used when establishing participants' opening account balances following a plan conversion.

Because there was no ERISA provision governing the creation of opening account balances at the time the plan was converted to a cash balance plan, the plan was free to set the opening account balances using a higher rate as long as the calculation did not decrease already accrued benefits under the pre-conversion defined benefit plan.[192]

[192] *Sunder v. U.S. Bancorp Pension Plan*, 586 F.3d 593, 47 EBC 2862 (8th Cir. 2009).

.70 Pension Equity Plans

.70.10 Pension Equity Plans Basics —

A pension equity plan is a defined benefit plan under which each participant's benefit is expressed as a single sum amount, rather than a periodic payment commencing on a participant's normal retirement date as is typical for a traditional defined benefit plan.[193] Like any other defined benefit plan, pension equity plans are covered by the ERISA plan termination insurance provisions and must make annual premium payments to the PBGC.

[193] TM Portfolio 352, Worksheet 9 IRS Pension Equity Plan Explanation of Issues.

A pension equity plan is a form of defined benefit plan because individual accounts are not actually established for plan participants. Instead, participants receive benefits equal to the lump sum value promised by the plan, regardless of the actual investment experience of the plan's trust.[194] For this reason, and assuming sufficient funding, participants' benefits under a pension equity plan generally are more predictable and secure than those provided under a defined contribution plan.

[194] TM Portfolio 352, Worksheet 7 Sample Pension Equity Plan Provisions (Excerpt).

A participant's benefit under a pension equity plan generally is determined by providing the participant with a percent of earnings credit for each year of service, which are accumulated throughout the participant's career with the employer, and then multiplying the total percentage (shown as a credit in some plans) by the participant's final average pay. Final average pay generally is defined as an annual average of the highest earnings over a specific number of years (e.g., the average of the highest 3 years of earnings).[195]

[195] TM Portfolio 352, Worksheet 7 Sample Pension Equity Plan Provisions (Excerpt).

Because pension equity plans are defined benefit plans, they are subject to ERISA's joint and survivor annuity and spousal consent requirements.[196] As a result, pension equity plan benefits must be available to participants in the form of an annuity.[197] Actuarial assumptions specified in the plan are used to convert participants' pension equity plan benefit to the various forms of annuity.

[196] ERISA § 205; I.R.C. 401(a)(11).

[197] I.R.C. 401(a)(25).

A pension equity plan is a type of defined benefit plan as defined in I.R.C. § 411(a)(13)(c), and, as such, is subject to the hybrid plan final regulations at 26 C.F.R. § 1.411(a)(13)-1 and 26 C.F.R. § 1.411(b)(5)-1.[198] Those regulations address in detail special vesting rules, safe harbor age discrimination, conversion protection, and market rate of return limitations.

[198] 26 C.F.R. § 1.411(a)(13)-1 and § 1.411(b)(5)-1.

.70.20 Advantages and Disadvantages of Pension Equity Plans for Employers —

Many of the advantages and disadvantages of cash balance plans also pertain to pay equity plans.[199]

[199] TM Portfolio 352 VI.B.: Comparing PEPs to Traditional Final Pay Plans and Cash Balance Plans.

Advantages to employers of pension equity plans may include the following:

- ***Simplified design:*** Pension equity plan benefit formulas are typically more readily understandable than traditional defined benefit plan formulas, making benefits easier to calculate, administer, and communicate.

- ***Universal coverage:*** As employers have shifted the primary retirement vehicle from traditional defined benefit plans to 401(k) plans, employees who are unable to contribute to the 401(k) plan receive no employer matching contributions and are left with minimal or no retirement savings. Pension equity plans can fill this gap since they generally cover all eligible employees, similar to a traditional defined benefit plan.

- ***Closer alignment with changing workforce demographics and career progression:*** As compared to traditional defined benefit plans, pension equity plans generally are more consistent with changing workforce demographics and career progression, given that pension equity plan benefits generally are more portable than traditional defined benefit plan benefits, and employees may change employers and careers many times during their working lives.

Disadvantages to employers of pension equity plans may include the following:

- ***Increased cost:*** Overall costs associated with pension equity plans may be greater than those of traditional defined benefit plans. For example, payment of benefits in the form of lump-sum distributions rather than monthly benefits results in an earlier reduction in plan assets and potential loss of gains from long-term investments, lower returns, lower assets, and higher contributions over time.

- ***Conversion issues:*** The conversion of a traditional defined benefit plan to a pension equity plan may result in certain participants receiving larger than expected benefits in retirement, and other participants receiving smaller than expected benefits in retirement, giving rise to potential claim and litigation risk. The complexity of the conversion process combined with the related participant risk puts significant pressure on the participant education and communication process.

- ***Legal complexity:*** Due to the unique nature of pension equity plans and the ever-evolving state of guidance, there is arguably additional complexity associated with ensuring legal compliance for pension equity plans. However, the IRS has opened the determination letter program for the period from Sept. 1, 2019, through Aug. 31, 2020, to allow submission of pension equity plans for favorable determination letters. For more, see *Determination Letter Process.*

.70.30 Advantages and Disadvantages of Pension Equity Plans for Employees —

Advantages for employees of pension equity plans may include:

- ***Built-in inflation protection:*** While pension equity plans and cash balance plans share methods of accumulating value, a major difference is in the earnings used to determine the benefit. Cash balance plans specify a credit each year, based on that year's earnings, while credits are applied to final earnings in a pension equity plan. This feature provides built-in inflation protection for pension equity plan participants because regardless of whether a participant is short-tenured or a long-service employee, benefits are based on earnings at the end of the employee's career.

- ***Guaranteed benefits:*** For employees, pension equity plans can be attractive because, unlike defined contribution plans, pension equity plan benefits are insured by the PBGC.

- ***Automatic coverage:*** Pension equity plans usually cover all employees, or large segments of an employer's population, without requiring participant contributions. Therefore, unlike traditional defined contribution plans, an employee does not have to decide whether to participate, how much to contribute or which investment options to select.

- ***Simplified design:*** Pension equity plans express benefits as a single lump sum value for each participant, which generally is easier for participants to understand than traditional defined benefit plan formulas.

- ***Reduced risk:*** Similar to traditional defined benefit plans, but unlike defined contribution plans, the employer bears all of the investment risk in a pension equity plan.

- ***Enhanced portability:*** Unlike a traditional defined benefit plan benefit, a participant's pension equity plan benefit can be rolled over into an individual retirement account or a new employer's plan following termination of employment.

- ***Availability of annuity options:*** As defined benefit plans, pension equity plans are required to offer participants annuity forms of payment in addition to the lump sum benefit, which is not required in a defined contribution plan. The availability of an annuity option provides pension equity plan participants additional flexibility when planning for retirement.

Disadvantages to employees of pension equity plans may include:

- ***Conversion complexity:*** The transition from a traditional defined benefit plan to a pension equity plan can be confusing for participants.

- ***No in-service withdrawal options:*** Unlike defined contribution plans, pension equity plans do not offer in-service distributions.

.70.40 Accumulated Benefit and Lump Sum-Based Benefit Formula —

The hybrid regulations set forth the qualification requirements for statutory hybrid plans, which are defined benefit plans that contain a statutory hybrid benefit formula.[200] The statutory hybrid formula is used to determine all or part of a participant's accumulated benefit, which is the current value of an accumulated percentage of the participant's final average compensation.[201] The accumulated benefit described in the hybrid regulations is different from a participant's accrued benefit under I.R.C. § 411(a)(7), but a statutory hybrid plan may express a participant's accumulated benefit as the current value of an accumulated percentage of the participant's final average compensation, even if the plan defines the participant's accrued benefit as an annuity beginning at normal retirement age that is actuarially equivalent to that value.[202]

[200] 26 C.F.R. § 1.411(a)(13)-1.
[201] 26 C.F.R. § 1.411(a)(13)-1.
[202] 26 C.F.R. § 1.411(a)(13)-1(d)(2).

A statutory hybrid benefit formula is a benefit formula that is either a lump sum-based benefit formula or a formula that has an effect similar to a lump sum-based benefit formula.[203]

[203] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(i).

Lump Sum-Based Benefit Formula. A lump sum-based benefit formula is a benefit formula that expresses a participant's accumulated benefit as the current value of an accumulated percentage of the participant's final average compensation.[204] Whether a benefit formula is a lump sum-based benefit formula is determined based on how participants' accumulated benefits are expressed under the terms of the plan, and the availability of a single-sum payment as an optional form of payment is irrelevant to this determination.[205] However, a benefit formula does not constitute a lump sum-based benefit formula unless:

[204] 26 C.F.R. § 1.411(a)(13)-1(d)(3)(i).
[205] 26 C.F.R. § 1.411(a)(13)-1(d)(3)(i).

- a distribution of benefits under the formula in the form of a single-sum payment equals the accumulated benefit under that formula (unless otherwise required under I.R.C. § 411(d)(6)); and

- the portion of the participant's accrued benefit under the formula and the then-current value of the accumulated percentage of the participant's final average compensation are actuarially equivalent, determined using reasonable actuarial assumptions, either upon the participant's normal retirement age or annuity starting date.[206]

[206] 26 C.F.R. § 1.411(a)(13)-1(d)(3)(i).

Formula with an Effect Similar to a Lump Sum-Based Benefit Formula. A benefit formula that is not a lump sum-based benefit formula has an effect similar to a lump sum-based benefit formula if the formula provides that the participant's accumulated benefit is expressed as a benefit that includes the right to adjustments for a future period, and the total amount of those adjustments is reasonably expected to be smaller for the participant than for any similarly-situated younger participant.[207] A right to adjustments for a future period is the right to any changes in the dollar amount of benefits over time, regardless of whether those adjustments are expressed as interest credits.[208] However, post-annuity starting date adjustments in the amount payable to a participant (e.g., cost-of-living increases), certain variable annuity benefit formulas and benefits properly attributable to certain employee contributions are all disregarded for purposes of determining whether a benefit formula has an effect similar to a lump sum-based benefit formula.[209] In addition, a benefit formula that provides for a reduction in a participant's benefit payable at early retirement age due to early commencement (with the result that the normal retirement benefit is greater than the early retirement benefit) is not treated as having an effect similar to a lump sum-based benefit formula, provided that the participant's normal retirement benefit is no less than the normal retirement benefit of a similarly-situated younger participant.[210]

[207] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(ii).
[208] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(ii).
[209] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(ii).

[210] 26 C.F.R. § 1.411(a)(13)-1(d)(4)(ii).

.70.50 Principal Credits and Interest Credits Under a Pension Equity Plan —

A pension equity plan must satisfy the accrual requirements of I.R.C. § 411(b) in order to be qualified under I.R.C. § 401(a). A pension equity plan is treated as failing to satisfy the requirements of I.R.C. § 411(b)(1)(H) (which provides that the rate of a participant's benefit accrual must not be reduced because of the attainment of any age) if the terms of the plan provide any interest credit, or an equivalent amount, for any plan year at a rate that is in excess of a market rate of return.[211]

[211] I.R.C. § 411(b)(5)(B)(i).

An interest credit generally means any of the following adjustments to a participant's accumulated benefit under a pension equity plan formula, to the extent not conditioned on current service and not made on account of imputed service:

- any 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

- any other increase for a period, under the terms of the plan at the beginning of the period.[212]

[212] 26 C.F.R. § 1.411(b)(5)-1(d)(1)(ii)(A).

A principal credit generally means any increase to a participant's accumulated benefit under a pension equity plan formula that is not an interest credit.[213] In the context of a pension equity plan, an increase in the accumulated benefit that is made on account of current service (including an increase on account of higher average compensation) constitutes a principal credit.[214]

[213] 26 C.F.R. § 1.411(b)(5)-1(d)(1)(ii)(D).

[214] IRS Notice 2016-67.

Explicit Interest and Implicit Interest PEPs. Pension equity plans generally are designed to provide a single-sum distribution equal to the accumulated benefit (i.e., 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, pension equity plans often provide for an increase in the amount of benefits that are payable to reflect the time value of money. Some pension equity plans provide for this increase by explicitly crediting interest on the accumulated benefit after principal credits cease (referred to as an *explicit interest PEP*).[215] In the case of 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.[216]

[215] IRS Notice 2016-67.

[216] IRS Notice 2016-67.

Other pension equity plans 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 (referred to as an *implicit interest PEP*).[217]

[217] IRS Notice 2016-67.

Example: An implicit interest PEP is a pension equity plan that defines the accrued benefit (i.e., 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 and preretirement mortality.[218]

[218] IRS Notice 2016-67.

Application of Market Rate of Return Regulations to Pension Equity Plans. 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 requirements described in the hybrid regulations.[219] For more on the market rate of return requirements under the hybrid regulations, see *Interest Credits in Cash Balance Plans.* As a result, in order for amendments to be eligible for I.R.C. § 411(d)(6) transition relief, any amendments necessary to bring the interest crediting rate under an explicit interest PEP into compliance with the market rate of return requirements under the hybrid regulations were required to be made prior to Jan. 1, 2017.[220]

[219] IRS Notice 2016-67.

[220] IRS Notice 2016-67.

By contrast, the preretirement interest that is implicit in applying a deferred annuity factor to the accumulated benefit in an implicit interest PEP is not included within the definition of interest credit under the hybrid regulations.[221] This is because the accumulated benefit remains a constant percentage of average compensation and is not adjusted with interest credits after principal credits cease. As a result, 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 I.R.C. § 411(d)(6) transition relief does not apply to such an amendment.[222]

[221] IRS Notice 2016-67.

[222] IRS Notice 2016-67.

Even though preretirement interest that is implicit in a deferred annuity factor under an implicit interest PEP is not currently subject to the market rate of return limitations, the Treasury Department and IRS are considering whether to propose amendments to the hybrid regulations that would subject implicit interest PEPs to the market rate of return limitations.[223] 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 limitations, the Treasury Department and IRS have indicated that plan sponsors will be given adequate time to amend their plans to comply with these requirements, and it is expected that I.R.C. § 411(d)(6) protection will be given for those amendments.[224]

[223] IRS Notice 2016-67.

[224] IRS Notice 2016-67.

.70.60 Accrued Benefits in Pension Equity Plans —

As a defined benefit plan, a pension equity plan must satisfy the accrued benefit requirements in 26 C.F.R. § 1.411(b)-1, which generally regulate the rate at which benefits can be earned and require that a defined benefit plan's normal retirement benefit meet at least one of three tests that are designed to prevent excessive *backloading* of benefits. The theory behind these rules is that highly compensated employees generally tend to remain with an employer longer and, if a plan provides low accruals in an employee's early years and much higher accruals in later years, this will have a discriminatory effect.

All of the three tests allow unlimited *frontloading* of benefits—a higher accrual rate in an employee's early years of service than in later years—but employers will still have to be careful about reducing benefit accruals because of the attainment of any age, as prohibited by I.R.C. § 411(b).

The three tests are:

- ***the fractional test,*** which generally requires that normal retirement benefits accrue no less quickly than ratably over an employee's career;
- ***the three percent test,*** which generally requires that an employee accrue at least three percent of his or her normal retirement benefit per year until 100 percent of that benefit has been accrued; or
- ***the 133 1/3 percent test,*** which generally requires that an employee's rate of benefit accrual in any given year not exceed 133 1/3 percent of the employee's accrual rate in any earlier year of service.[225]

[225] 26 C.F.R. § 1.411(b)-1(b)(1) through 26 C.F.R. § 1.411(b)-1(b)(3).

The most natural test for pension equity plans to satisfy is one that compares one year to any prior year. Thus, pension equity plans most commonly rely on the 133 1/3 percent test.

.70.70 Decrease in Accrual Due to Attainment of an Age Prohibited in Pension Equity Plans —

A pension equity plan does not satisfy the minimum vesting standards of I.R.C. § 411(a) if, under the terms of the plan, participants' benefit accruals are discontinued or the rate of participants' benefit accrual is reduced because of the attainment of any age. However, a plan can place a ceiling on the maximum benefit that an individual can accrue, or limit the number of years of service that will be taken into account in computing accrued benefits.[226]

[226] I.R.C. § 411(b)(1)(H)(i).

A pension equity plan will fail to comply with the requirements of I.R.C. § 411(b)(1)(H) if, either directly or indirectly, a participant's rate of benefit accrual is reduced, including stopping plan participation or accrual, because of the participant's attainment of any age.[227] This means that an individual who is or who could be a plan participant cannot receive a lower accrual rate just because that individual is older. An indirect reduction in benefit accrual for older workers might occur when younger workers are assigned to a different division even though they do the same work as older employees, and the younger division has a higher accrual rate. Assignment to a specific division would be a proxy for being older or younger, according to the rule's preamble.[228] Similarly, an impermissible reduction in benefit accrual may occur if an employee's service after attainment of Social Security retirement age is disregarded for benefit accrual purposes.[229]

[227] Prop. 26 C.F.R. § 1.411(b)-2, 67 Fed. Reg. 76123 (Dec. 11, 2002).
[228] Prop. 26 C.F.R. § 1.411(b)-2, 67 Fed. Reg. 76123 (Dec. 11, 2002).
[229] Prop. 26 C.F.R. § 1.411(b)-2, 67 Fed. Reg. 76123 (Dec. 11, 2002).

.70.80 Vesting Schedules in Pension Equity Plans —

Pension equity plan participants must become fully vested in their plan benefits after no more than three years of service.[230] This three-year vesting requirement applies with respect to a participant's entire accrued benefit, even if only a portion of the participant's accrued benefit under the plan is determined under a statutory hybrid benefit formula.[231]

[230] I.R.C. § 411(a)(13)(b).

[231] 26 C.F.R. § 1.411(a)(13)-1(c)(1).

Similarly, the three-year vesting requirement also may apply to a participant's entire accrued benefit derived from the greater of two or more benefit amounts under a plan, when each amount is determined under a different benefit formula.[232] This could include a benefit determined pursuant to an offset among formulas within the plan or a benefit determined as the greater of a protected benefit under I.R.C. § 411(d)(6) and another benefit amount. If at least one of these benefits is a benefit calculated under a statutory hybrid benefit formula, the three-year vesting requirement applies to that participant's entire accrued benefit under the plan, even if the participant's benefit under the statutory hybrid benefit formula is ultimately smaller than the participant's benefit under the other formula.[233]

[232] 26 C.F.R. § 1.411(a)(13)-1(c)(1).

[233] 26 C.F.R. § 1.411(a)(13)-1(c)(1).

.70.90 Distributions From Pension Equity Plans —

Pension equity plan participants can receive benefits in annuity form or, if the plan so provides, in the form of a lump sum distribution.

Prior to the passage of the PPA and the hybrid regulations, distributions from pension equity plans presented significant challenges for employers due to the *whipsaw effect*. The IRS previously took the position that a lump-sum distribution from a pension equity plan was not determined simply and directly by the participant's single sum benefit.[234] Instead, the IRS required that the single sum benefit be projected to retirement age and converted to a retirement annuity using the interest rate and mortality assumptions specified in the plan.[235] Then, to derive the amount of the lump-sum distribution, the retirement annuity was required to be converted back to a lump sum and discounted to the participant's current age using the interest rate and mortality table specified in I.R.C. § 417.[236] If this latter interest rate was lower than the plan rate, the difference between the single sum benefit and the lump sum value could be substantial, resulting in a distribution substantially greater than the value of the single sum benefit (also referred to as *whipsaw* or the *whipsaw effect*).

[234] IRS Notice 96-8.

[235] IRS Notice 96-8.

[236] IRS Notice 96-8.

The PPA eliminated the *whipsaw* problem by allowing a lump-sum distribution of the single sum benefit so long as the plan's interest crediting rate does not exceed a market rate of return.[237]

[237] I.R.C. § 411(a)(13)(A), added by §701(b)(2) of the 2006 PPA, Pub. L. No. 109-280, and amended by Pub. L. No. 110-458, § 107(b)(2), effective as if included in the 2006 PPA.

.70.100 Minimum Required Distributions From Pension Equity Plans —

Pension equity plans also are subject to the I.R.C.'s *minimum required distribution rules*. These rules require that, for distributions during a participant's lifetime, the plan must provide that a participant's entire benefit:

- will be distributed on or before the participant's *required beginning date*; or
- will be distributed beginning no later than the participant's required beginning date, over the participant's life, the lives of the participant and a designated beneficiary or over a period that does not extend past the life expectancy of the participant (according to IRS rules) or that of the participant and his or her designated beneficiary.[238]

[238] I.R.C. § 401(a)(9).

In general, the required beginning date for an employee that is not a 5%-or-more owner is April 1 of the year following the later of the year in which the participant turns age 70 $^1/_2$ or the year in which he or she retires.[239]

[239] I.R.C. § 401(a)(9) as amended by Small Business Job Protection Act, Pub. L. No. 104-188, § 1404.

Once benefit payments must begin, they must continue every year in an amount determined under IRS rules. Failure to distribute at least the amount required under these rules in any year could jeopardize plan qualification. In all cases, it will result in the imposition of an excise tax. Special minimum required distribution rules apply where the participant dies before the benefits have been completely distributed.[240]

[240] I.R.C. § 401(a)(9).

.70.110 Nondiscrimination Requirements for Pension Equity Plans —

A pension equity plan must provide contributions or benefits that do not discriminate in favor of highly compensated employees (HCEs). There is no safe harbor test prescribed for pension equity plans. As a result, rate group testing must be performed, and the pension equity plan may test accrual rates or equivalent allocation rates. For more, see *Nondiscrimination Rules: Testing.*

.70.120 Anti-Cutback Rule's Impact on Pension Equity Plans —

The anti-cutback rule generally prohibits a qualified plan from decreasing a participant's accrued benefit by a plan amendment.[241] Because of this, an employer must use caution when amending a pension equity plan to reduce any accrued benefit or amending a traditional defined benefit plan to convert it into a pension equity plan. In the event of conversion, the pension equity plan must satisfy the special rules for plan conversion amendments set forth in the hybrid regulations.[242] In addition, the pension equity plan must preserve any optional form of benefit that applied to the previously accrued traditional defined benefit plan benefit.[243] For more on the anti-cutback relief provided to certain pension equity plan amendments made to comply with the market rate of return requirements, see *Principal Credits and Interest Credits in Pension Equity Plans.*

[241] I.R.C. § 411(d)(6).

[242] 26 C.F.R. § 1.411(b)(5)-1(c).

[243] 26 C.F.R. § 1.411(d)-4. Q&A-1.

.70.130 Benefit Limitations in Pension Equity Plans —

Pension equity plans must meet the I.R.C. maximum limit on accrued benefits applicable to defined benefit plans. For more, see *Employee Benefits COLA Chart.*

.80 Target Benefit Plans

.80.10 Target Benefit Plan Basics —

Another type of plan that incorporates features normally associated with both defined benefit and defined contribution plans is the *target benefit plan*. Such plans offer many of the advantages of defined benefit plans with less expense. The benefit formula is stated in a similar manner to the formula under a traditional defined benefit plan and therefore favors older employees, who are often the owners of the sponsoring employer. However, unlike traditional defined benefit plans, a target benefit plan does not promise a fixed benefit at retirement. Because a target benefit plan is a defined contribution plan, each participant has an individual account and the ultimate retirement benefit depends upon the investment performance of the funds allocated to that account.[244]

[244] I.R.C. § 414(i); TM Portfolio 352, Worksheet 3 Target Benefit Plan Contribution Language (Excerpt).

Like a defined benefit plan, a target benefit plan's benefits are expressed in terms of a number of dollars or a percentage of compensation to be paid out periodically starting at retirement. Unlike a defined benefit plan, the amount of these benefits is not promised. The stated benefit in the plan document is only a goal or target. The employer sets aside funds calculated to reach that goal, as determined by an actuary. The funds are then invested in individual accounts. If the investment earnings exceed the actuarially assumed earnings, the retirement benefit will be greater than the target. If they fall below, the benefit will be less.[245]

[245] Rev. Rul. 76-464.

Because older employees have less time to accumulate funds for retirement, actuarially greater contributions can be made to their accounts. Older employees also tend to have higher compensation levels, meaning benefit formulas geared to a percentage of compensation at retirement will entitle the accounts of older employees to receive greater contributions than those of younger employees. Hence, a target benefit plan, while required to cover younger employees under the I.R.C. nondiscrimination rules, may be more advantageous and less expensive than a traditional defined contribution plan providing for a fixed percentage of annual contributions to be made to the accounts of all employees.

The requirements for a target benefit plan are:

- ***Money Pension Plan:*** A target benefit plan is a money purchase pension plan, and generally is governed by the qualification rules applicable to pension plans.

- ***Stated Benefit:*** A target benefit plan must provide a stated benefit commencing at the plan's normal retirement date.

- ***Individual Level Premium Funding:*** The contributions necessary to fund the plan's stated benefit must be determined under the individual level premium funding method (a method that spreads pension costs out evenly over a period of years) using actuarial assumptions or factors stated in the plan.

- ***Separate Accounting and Allocation Requirements:*** The contributions determined under the individual level premium funding method, and any forfeitures reducing those contributions, must be allocated and separately accounted for with respect to each participant.

- ***Sources of Benefits:*** The plan's benefits must be provided solely from the amounts of contributions and forfeitures allocated to a participant's account, employee contributions, and any income, expenses, gains and losses thereon.[246]

[246] Rev. Rul. 76-464.

26 C.F.R. § 1.401(a)(4)-8(b)(3) provides a *safe harbor* method for passing applicable nondiscrimination requirements. It does not include the sole means of determining target benefit plan contributions, but any deviation from the provisions of that regulation will require annual nondiscrimination testing, since target benefit plans are defined contribution plans.[247]

[247] 26 C.F.R. § 1.401(a)(4)-8(b)(3).

.80.20 Target Benefit Plan Advantages and Disadvantages —

Prior to 2002, target benefit plans were more popular than profit sharing plans because higher deduction limits were available for employers who sponsored target benefit plans. Effective as of Jan. 1, 2002, the deduction limits are the same, and target benefit plans have greatly decreased in popularity while profit sharing plans have become more standard.[248]

[248] I.R.C. § 404(a)(3), as amended by EGTRRA § 616.

> ***Practice Tip:*** A target benefit plan may be an appealing option for a small employer that wishes to direct a large amount of contributions to older or more highly paid employees. Target benefit plans tend to be less expensive to operate than traditional defined benefit plans because the amount of actuarial computation is less (no actuarial certification is needed with the annual report on Form 5500) and the plan is not liable for annual PBGC insurance premiums. Separate accounts enable participants to separately direct the investment of their accounts if the plan offers that option.

On the downside, target benefit plans may have higher administrative costs than money purchase plans (due to the need for some actuarial work) but, like money purchase plans, still are subject to the defined contribution plan limit on maximum annual allocations to a particular participant's account.[249]

[249] Rev. Rul. 76-464.

.90 Age-Weighted Profit-Sharing Plans

.90.10 Age-Weighted Profit-Sharing Plan Basics —

Profit-sharing plans traditionally allocate the employer's contributions to each eligible participant's account based on the participant's compensation for the year. Profit-sharing plans are flexible, because an employer's contributions may vary from year to year at its discretion. For more on profit-sharing plans, see *Profit-Sharing and Stock Bonus Plans.*

An age-weighted profit-sharing plan is a plan that allows an employer to factor a participant's age and compensation into determining how plan contributions will be allocated.[250] Age-weighted profit-sharing plans resemble defined benefit or target benefit pension plans, because such plans take age into account. However, defined benefit and target benefit pension plans have very limited flexibility from one year to the next for employer contributions, while age-weighted profit-sharing plans have all of the flexibility of a profit-sharing plan.

[250] See 26 C.F.R. § 1.401(a)(4)-8.

Employers may want to skew their contributions to older employees to meet several objectives such as:

- to counter the otherwise frontloaded nature of the profit-sharing plan;
- to ensure that older employees receive adequate retirement income;
- to supplement contributions under a 401(k) plan; or
- to favor certain older key employees.

Age-graded designs were not common in practice before the IRS issued its final nondiscrimination regulations in 26 C.F.R. § 1.401(a)(4)-8, because it was perceived that this design would be considered discriminatory by the IRS.

As discussed below, under IRS's final nondiscrimination regulations, an employer may maintain a qualified profit-sharing plan in which the participant's age is considered when allocating the employer's contributions. As a result, if these rules are met, a profit-sharing plan can be designed to provide larger amounts to older employees than to younger employees.[251]

[251] See 26 C.F.R. § 1.401(a)(4)-8.

.90.20 Nondiscrimination Requirements for Age-Weighted Profit-Sharing Plans —

An age-weighted profit-sharing plan, like all qualified retirement plans, is subject to I.R.C. § 401(a)(4), which prohibits discrimination in favor of HCEs.

Under I.R.C. § 414(q), HCEs include:

- owners of 5% or more of the business during the year or preceding year; or
- employees who, for the preceding year, earn up to the compensation limit, as indexed for inflation) (for the current HCE compensation limit, see *Employee Benefits COLA Chart*; or
- if the employer elects, are in the top-paid group (i.e., the top 20% of employees based on compensation).[252]

[252] IRS Notice 2018-83.

A plan may be considered discriminatory if the HCEs receive proportionately larger employer contributions, or accrue proportionately larger employer-derived benefits, than the non-highly compensated employees (NHCEs). Contributions and benefits are measured as a percentage of the current year's compensation, and plans may take into account *permitted disparity* (i.e., a plan may be integrated with Social Security to provide somewhat larger contributions or benefits to participants earning more than the Social Security wage base). For more, see *Permitted Disparity*. This nondiscrimination test must be satisfied each year. For more, see *Nondiscrimination Rules: Testing*.

Defined contribution plans can meet the nondiscrimination requirements through “cross-testing.” A defined contribution plan is cross-tested by converting employer contributions into benefits that participants expect to receive by determining the annuity benefit that each participant's allocation plus future interest could purchase at normal retirement age. It is these hypothetical annuities, rather than the actual allocations, that are tested for nondiscrimination, much as if the plan were a defined benefit plan.[253]

[253] 26 C.F.R. § 1.401(a)(4)-8.

Under cross-testing, the same allocation for a younger employee will be projected to earn more interest, and thus convert to a larger annuity, than for an older employee.

Practice Tip: This means that the same rate of allocation for all employees will produce higher equivalent accrual rates for younger employees. Therefore, a plan can provide a lower allocation rate for younger employees and a higher allocation rate for older employees and still pass the nondiscrimination test because the resulting equivalent benefit accrual rates will be nondiscriminatory.

Under 26 C.F.R. § 1.401(a)(4)-8(b)(2)(ii), benefits are determined under the following steps:

• Determine the employer's allocations to the participant's account for the plan year. The regulations provide that this amount is equal to the increase in the participant's account balance during the measurement period, which in this case is the plan year.

• Project the amount determined in the first step forward, with interest, until the participant's testing age. The participant's testing age generally will be age 65, unless the plan specifies a uniform normal retirement age for all participants that is younger than age 65.

• Convert the sum determined in the second step to a straight life annuity by dividing the sum by a straight life annuity factor for the participant's testing age.

• Express the annuity determined in the third step as a percentage of the participant's compensation.[254]

[254] 26 C.F.R. § 1.401(a)(4)-8(b)(2)(ii).

One of the most straightforward ways to use this method is to take the contribution for an HCE and convert it to its equivalent benefit accrual rate under the cross-testing rules. Having done that, each other participant's contribution can be determined by assigning the same equivalent benefit accrual rate to them, and then working backwards through the cross-testing rules to solve for their contribution.

Example: Assume that Sarah, an HCE, is 55 and earns $150,000. The employer wants to make a $30,000 contribution. Using 8% interest and UP-1984 mortality table, Sarah's equivalent benefit accrual rate would be determined as follows: The contribution is projected to earn 8% interest until age 65, which would accumulate to $64,768 ($30,000 times 1.08 to the 10th power). The $64,768 at age 65 is divided by an annuity factor of 8.196, to determine the equivalent annual benefit commencing at 65 of $7,902. The annual benefit of $7,902 is divided by Sarah's compensation of $150,000, to determine the equivalent benefit accrual rate of 5.27%.[255]

[255] 26 C.F.R. § 1.401(a)(4)-8(b)(2)(ii).

Any other participant's contribution may be determined by simply reversing this methodology, assuming the participant has an equivalent benefit accrual rate of 5.27%.

Example: Christopher is 47 and earns $60,000. His contribution would be determined as follows: The benefit accrual rate of 5.27%is multiplied by his pay of $60,000, to determine an annual benefit commencing at age 65 of $3,160. The benefit is multiplied by the annuity factor of 8.196 to determine the single sum equivalent at 65 of $25, 906. The $25,906 single sum amount at age 65 is discounted to its present value at his current age of 47, by dividing it by 1.08 to the 10th power resulting in a present value of $6,483, which is his contribution.[256]

[256] 26 C.F.R. § 1.401(a)(4)-8(b)(2)(ii).

This example illustrates the benefits of cross-testing, because a $30,000 contribution was made for the HCE and a $6,483 contribution was made for the NHCE. The plan is nondiscriminatory, because under cross-testing each participant has the same 5.27% accrual rate.

.90.30 Top-Heavy Rules in Age-Weighted Profit-Sharing Plans —

An age-weighted profit sharing plan, like any defined contribution plan, must provide for minimum top-heavy contributions if the plan is top-heavy as required by I.R.C. § 416. For more, see *Key Employees and Top-Heavy Provisions.* The plan would presumably have to satisfy the top-heavy minimum requirements on a contributions-basis. Thus, a minimum contribution of 3% for every non-key employee would be required.

In most cases, the top-heavy minimum will not adversely affect the age-weighted design. However, its effect should be considered in several respects.

• First, if it is likely that the plan will be top-heavy, it may be simpler to provide a minimum contribution of 3%, so that a participant would receive the greater of 3% and the allocation produced by the age-weighted design.

• Second, the requirement to make top-heavy contributions can affect the employer's total contribution and how it is apportioned among participants. If it is likely that the plan will be top-heavy, then these effects should be considered when designing the plan.

• Finally, it is possible that top-heavy contributions could jeopardize the implicit safe harbor of an age-weighted design if there are relatively young HCEs who are also non-key employees. These employees, because of their ages, might get a fairly modest allocation under an age-weighted design. However, as non-key employees, they are entitled to the top-heavy minimum of 3%. If these are more than the contributions they would otherwise have received under the age-weighted design, then the contributions will convert to a higher accrual rate than the age-weighted design was intended to produce. Since these employees are HCEs, the cross-testing rules would not be met.[257]

[257] 26 C.F.R. § 1.401(a)(4)-8 and I.R.C. § 416.

.100 New Comparability Plans

.100.10 New Comparability Plan Basics —

Another variation of the hybrid plan is the *new comparability plan*. These plans are defined contribution plans that also are designed to take advantage of the IRS cross-testing method for purposes of passing nondiscrimination testing, but which do not base the allocation rate on age.[258] There is not much specific guidance on new comparability plans and plan designs vary widely based on the types of target groups outlined in the plan.

[258] 26 C.F.R. § 1.401(a)(4)-8.

.100.20 Flexible Plan Design in New Comparability Plans —

Although there is no single design that comprises a new comparability formula, plans can be designed to provide a more uniform allocation to a segment of the workforce than can be provided under an age-weighted profit-sharing plan.

Example: Assume a plan wants to provide a $15,000 allocation to two HCEs with different ages. A new comparability formula could be tailored to provide a uniform allocation for all NHCEs at a rate that is predetermined to provide an equivalent accrual rate to the HCEs' contributions allowing the plan to pass the nondiscrimination test under the cross-testing rules while providing the targeted contribution to the HCEs.[259]

[259] 26 C.F.R. § 1.401(a)(4)-8.

This formula could be attractive to employers worried about employee relations that can arise with age-weighted profit-sharing plans, because a uniform allocation is provided to all NHCEs, and there are no age-based variations to explain.

.100.30 IRS Nondiscrimination Concerns Regarding New Comparability Plans —

The IRS announced it was looking closely at the application of nondiscrimination rules to new comparability plans. The IRS examined whether it was appropriate in all cases, without regard to plan structure, to allow the projected future value of employer contributions to be tested as the equivalent of employer-provided benefits under a defined benefit plan.[260]

[260] IRS Notice 2000-14.

The IRS was concerned by new comparability plans that may offer HCEs allocation rates reaching 18% to 20%, while NHCEs receive rates as low as 3%.[261]

[261] IRS Notice 2000-14.

In companies with enough young NHCEs, the small allocations projected over time may enable an employer to demonstrate compliance with the nondiscrimination rules. Cross-testing may achieve this result even though older workers with high compensation are getting substantially larger allocations. In some situations, NHCEs never have an opportunity to earn the higher allocation rates as they work additional years and grow older.[262]

[262] IRS Notice 2000-14.

Also troubling to the IRS was the replacement of an existing defined contribution plan with a new comparability plan, as rank-and-file employees may suffer significant reductions in their allocation rates, while owners and executives may benefit from a significant increase in their allocation rates.[263]

[263] IRS Notice 2000-14.

As a result of its examination, the IRS issued regulations that prescribe conditions that new comparability plans must satisfy if they are to use the cross-testing method to determine compliance with nondiscrimination requirements.

These regulations permit defined contribution plans with broadly available allocation rates to continue using nondiscrimination testing available under I.R.C. § 401(a)(4) regulations. The rules also create a minimum allocation *gateway* that would identify other plan designs with the greatest disparity between benefits provided to HCEs and NHCEs.[264]

[264] 26 C.F.R. § 1.401(a)(4)-8(b)(1) and 26 C.F.R. § 1.401(a)(4)-9(b)(2)(v).

The rule liberalizes the determination of whether a plan has broadly available allocation rates. Two allocation rates may be aggregated in a manner similar to the rule allowing aggregation of certain benefits, rights and features in the nondiscrimination tests. This provision means that NHCEs with a higher allocation rate may be used to support those with a lower rate. In addition, differences in allocation rates resulting from permitted disparity (integration of the plan's benefits with Social Security) under I.R.C. § 401(l) regulations may be disregarded.

The rule also allows certain transition allocations to be disregarded, including defined benefit replacement allocations, pre-existing replacement allocations or pre-existing merger or acquisition allocations. These transition allocations must be provided to a closed group of employees and established under plan provisions. Once the allocations are established, they cannot be changed, except to reduce the allocations of HCEs or because of de minimis changes (such as a change in the definition of compensation to include I.R.C. § 132(f) elective reductions).[265]

[265] 26 C.F.R. § 1.401(a)(4)-8(b)(1) and 26 C.F.R. § 1.401(a)(4)-9(b)(2)(v).

The following are the basic conditions for determining whether an allocation is a defined benefit replacement allocation.

Defined benefit replacement allocations are:

• provided to a group of employees who formerly benefited under an established defined benefit plan of the employer or prior employer that provided age-based equivalent allocation rates;

• calculated to replace the retirement benefits that the employee would have been provided under the defined benefit plan if the employee had continued to benefit under that plan;

• provided to employees who receive no other allocations under the plan for the plan year (except as provided in the regulations); and

• provided to a nondiscriminatory group of employees.[266]

[266] IRS Rev. Rul. 2001-30.

Pre-existing replacement allocations are provided under a plan provision adopted before June 29, 2001, to employees who formerly benefited under a defined benefit plan and are reasonably calculated to replace the benefit under that plan.

Pre-existing merger and acquisition allocations are:

• established after a stock or asset acquisition, merger, or similar transaction occurring before Aug. 28, 2001, for a group of employees employed by the acquired trade or business;

• provided for a class of eligible employees that is closed no later than two years after the transaction, or January 2002, if earlier;

• provided under a plan amendment adopted by the date the class was closed; and

• calculated to replace the retirement benefits the employees would have received under the prior plan if the new employer had continued that plan.[267]

[267] IRS Rev. Rul. 2001-30.

The rule establishes a gateway prescribing minimum allocation rates for NHCEs.[268] Plans excepted from the gateway are those with age-based allocation rates. There is an exception for plans with gradual age or service schedules, and for plans that provide for allocation rates based on a uniform target benefit allocation.

[268] 26 C.F.R. § 1.401(a)(4)-9(b)(2)(v)(D).

A gradual age or service schedule if the schedule of allocation rates is available to all participants in the plan and provides for rates that increase smoothly at regular intervals. There were concerns that the allocation rates of younger employees may be reduced to achieve a smooth progression. In response, under the final rules, a plan's schedule of allocation rates does not fail to increase smoothly at regular intervals merely because a specified minimum uniform allocation rate is provided for all participants or because the minimum benefit for top-heavy plans is provided for all NHCEs if certain conditions are satisfied.[269]

[269] 26 C.F.R. § 1.401(a)(4)-8(b)(1)(iv).

A defined contribution plan satisfies the gateway if each NHCE in the plan has an allocation rate that is at least one-third of the allocation rate of the HCE with the highest allocation rate, and that a plan is deemed to satisfy this gateway if each NHCE received an allocation of at least 5% of the NHCE's compensation (within the meaning of I.R.C. § 415(c)(3)).

In addition, a plan may satisfy the gateway requirement by providing an allocation of at least 5% of compensation that is prorated for an employee who participates in the plan for less than a year.[270]

[270] 26 C.F.R. § 1.401(a)(4)-8(b)(1); 26 C.F.R. § 1.401(a)(4)-9(b)(2)(v).