Overview of Hybrid Plans (Cash Balance and Pension Equity Plans)

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INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

Overview

Introduction

Cash balance and other hybrid plans contain features of both defined benefit (DB) and defined contribution (DC) plans. This allows the plan sponsor and participants to take advantage of features of both types of plans.

One key reason for the growth of cash balance plans was the improved ease of understanding of a participant's retirement benefit. Another reason was the movement to retirement income based on lump sum values, similar to 401(k) savings plans, and the availability of lump sum payment options.

More recently, small employers have adopted cash balance plans since defined benefit plans may provide higher retirement income than defined contribution plans.

However, these features have raised issues as to how these plans should comply with various rules for DB plans. As a result, these plans have been subject to a great deal of controversy, and the IRS had suspended review of these cases for a number of years, pending resolution of the issues surrounding these plans.

The purpose of this lesson is to provide an overview of cash balance and other hybrid plans and provide guidance for identifying potential issues associated with these types of plans.

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Objectives

At the end of this chapter, you will be able to identify and verify if provisions of hybrid plans (cash balance and/or pension equity plans) satisfy the applicable requirements. Therefore, you will be able to:

- Define a hybrid plan.
- Identify the primary features and requirements of a cash balance plan and a pension equity plan.
- Explain the "A plus B" method.
- Define principal and interest credits.
- Explain the interest crediting standards for cash balance plans, including the market rate and the preservation of capital requirements.
- Calculate the hypothetical account balance when given a plan formula.
- Calculate the accrued benefit.
- Explain the similarly situated employee requirement.
- Explain the special vesting rule for cash balance plans.
- Explain the present value of the accrued benefit for cash balance plans.
- Determine if the plan complies with the 133 1/3% rule.

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Overview, Continued

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Types of Retirement Plans

Two Main Types

IRC section 414 provides that there are two main types of retirement plans:

- Defined contribution (DC) plans, and
- Defined benefit (DB) plans.

DC Plan Defined

Under section 414(i), a DC plan is defined as a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account. Also, the account includes any income, expenses, gains and losses, and any forfeitures of accounts of other participants.

Examples of DC plans include section 401(k) plans, profit sharing plans and section 403(b) plans.

DC Plan Characteristics

Some of the characteristics of a DC plan include:

- Separate accounts are created for each participant which reflect allocations, gains/losses, expenses and reallocated forfeitures received.
- The account balance is not guaranteed by the Pension Benefit Guaranty Corporation (PBGC).
- Money purchase plans are subject to IRC § 430 funding requirements.
- The participants assume the risk of investment gains and losses.
- DC plans are **not** subject to the accrual rules under IRC § 411(b).

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Definition of a DB Plan

Under section 414(j), a DB plan is defined as any plan which is not a DC plan. Some of the characteristics of a DB plan include:

- The participant's benefit is determined as of his/her normal retirement age (NRA).
- Benefits are guaranteed by the PBGC, with some exceptions.
- DB plans, excluding multiemployer plans, are subject to IRC section 430 funding requirements.
- The employer assumes the risk of investment gains and losses.
- DB plans are subject to the accrual rules under IRC section 411(b).

Hybrid Plans-Introduction

Definition of Hybrid Plan

The Internal Revenue Code uses the term Applicable Defined Benefit Plan to describe hybrid plans whereas the regulations use the term Statutory Hybrid Plans for the same purpose. Essentially each defines a hybrid plan as:

- The balance of a hypothetical account maintained for the participant (i.e., cash balance plan), or
- As an accumulation percentage of the participant's final average compensation (i.e., pension equity plan (PEP)).

For purposes of this chapter, we will use the term hybrid plans to refer to cash balance and PEP plans that meet the statutory requirements.

Cash Balance Plans

Cash balance plans incorporate features of both defined contribution and defined benefit plans, but are technically defined benefit plans.

To a participant, a cash balance plan looks like a DC plan:

- Each participant has an "account" that grows with annual credits. These credits are:
    - Interest credits which are calculated based on the amount of assets in the participant's account and,
    - Principal credits, which are generally a specified dollar amount or calculated as a percentage of the participant's pay.

In many plans, the participant is permitted to receive a lump sum distribution of the vested balance in his or her "account" upon retirement or separation from service at any age.

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Cash Balance Plans (continued)

However, cash balance plans are actually DB plans:

- The participant "accounts" are recordkeeping accounts only and are commonly referred to as hypothetical accounts.
- The employer does not make contributions to accounts for individual participants. Instead, the employer makes contributions to the plan's trust, based on the minimum funding requirements for DB plans.
- The interest credits are based on the plan's provisions, generally not the actual return on the plan's assets.
- The employer (not the employee) assumes the responsibility for investment gains and losses.

No actual assets are associated with participant accounts. Assets are pooled and benefits may be reduced if the plan terminates while it is under funded.

Primary Characteristics of Hybrid Plans

Introduction

This section provides the primary characteristics of a hybrid plan. The characteristics mentioned in this section will be covered in more details in the following sections below. After the characteristics are discussed, PEP plans will be covered. Finally, the chapter will discuss the background and history of hybrid plans.

Primary Characteristics

The primary characteristics of a hybrid plan are as follows:

1. Accumulated Benefit and "A plus B" Requirement

The participant receives an accumulated benefit, which is the current balance of a hypothetical “account” that grows with annual credits. See Treas. Reg. section 1.411(a)(13)-1(d)(2).

Traditional DB plans can be converted into a hybrid plans. For such converted plans, the conversions must meet the "A plus B" method under the Pension Protection Act of 2006 (PPA '06). This is conversion protection if the plan began life as a traditional DB plan and was converted to a hybrid plan.

2. Annual Credits-Principal and Interest

The plan will provide for a formula that is used to determine the balance of a hypothetical account, and will have credits for the hypothetical account.

These are two types of credits for a hypothetical account, as defined in § 1.411(b)(5)-1(d)(1)(ii) of the regulations:

- Interest credits (calculated based on the amount of assets in the participant’s account), and
- Principal credits (generally a specified dollar amount or calculated as a percentage of the participant’s pay)

3. Interest Crediting Rate

The interest crediting rate must not exceed a market rate of interest.

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Primary Characteristics of Hybrid Plans, Continued

4. Preservation of Capital Requirement

The plan must provide for the preservation of capital. Thus, upon distribution, the hypothetical account may not be less than the sum of principal credits without any interest credits.

5. Vesting

PPA '06 requires a special vesting rule (100% after three years) for hybrid plans.

6. Accrual Rules

The hybrid plan must meet the accrual rules applicable to a DB plan.

- A hybrid accrued benefit must meet the "similarly situated" requirement.
- Hybrid plans are deemed to meet section 417(e) when determining the present value of the accrued benefit.

Other Requirements for Hybrid Plans

Introduction

Hybrid plans must meet other requirements:

- The nondiscrimination requirements under IRC section 401(a)(4).
- One of the accrual rules under section 411(b)(1). Most plans meet the 133 1/3% rule.

Accumulated Benefit and the "A plus B" Method

How a Hybrid Plan Begins

Hybrid plans can come into existence in two ways:

- An existing DB plan can be converted to a hybrid plan with or without an opening balance, or
- The employer adopts a new hybrid plan. Note that an employer can adopt a new hybrid plan even if the employer currently sponsors another DB plan or had previously sponsored a DB plan.

Accumulated Benefit and Hypothetical Account

An accumulated benefit is generally defined as the current balance of a hypothetical account. See Treas. Reg. Section 1.411(a)(13)-1(d)(1).

PPA '06 Changes

PPA '06 addresses conversions after June 29, 2005. PPA '06 does not apply to conversions prior to that date. Thus, the rules for earlier conversions will be defined by prior law, interpretation, and the outcome of litigation.

The Accrued Benefit prior to the Conversion

If a plan sponsor converts a DB plan to a hybrid plan, the present value of the accrued benefit will become the opening balance in the hypothetical account. This pre-conversion accrued benefit must be at least as great as the lump sum determined using the 417(e) assumptions. (See example 8). Future credits will be added to the opening balance of the hypothetical account.

However, in some situations, the plan sponsor may **not** convert the prior annuity based formula to an opening balance in the hybrid plan. Under this approach, the annual benefit payable at normal retirement age may be frozen at the date of the conversion and future benefits would be earned under the cash balance account according to the plan's formula.

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"A plus B" Method

Under either approach (whether or not the participant's accrued benefit is converted and added to the hypothetical balance), the hypothetical account is to be credited with interest and principal credits immediately after the conversion.

The “A plus B” method is as follows:

A. frozen accrued benefit up to the point of conversion, including early retirement subsidies if the participant is eligible for a subsidy when he or she actually retires, plus

B. additions to the hypothetical account in accordance with plan's formula after the conversion.

For conversions after June 29, 2005, PPA ‘06 provides that the conversion from a traditional DB plan to a cash balance plan does not discriminate with respect to age if a participant’s benefit is no less than the “A plus B” method. The “A plus B” method eliminated the "wear-away" approach. See below for more detailed discussion of wear-away.

Example 1 Illustrating a Traditional DB Plan

Dade Company sponsors a traditional defined benefit plan. The annual benefit payable at normal retirement age (NRA) for the life of the participant is defined as;

1% x Final Average Earnings (FAE) x Years of service.

For example, on December 31, 2008, Leah, age 50 with 20 years of service, has FAE of $90,000. Leah's accrued benefit is determined as follows:

1. Benefit percent = 1%
2. FAE = $90,000
3. Service = 20 years
4. Accrued benefit payable at NRA for life =

   1 x 2 x 3, or

   1% x 20 x $90,000 = $18,000

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Accumulated Benefit and the "A plus B" Method, Continued

Example 2- Illustrating "A plus B" Method

Same facts as prior example, except that the plan sponsor amends the plan to convert the DB plan into a cash balance plan on January 1, 2009. The principal or pay credit is 4% of compensation.

The plan sponsor does not convert Leah's accrued benefit to an amount that will become the hypothetical account balance. Thus, on December 31, 2009, the end of the plan's first plan year as a cash balance plan, Leah's benefit will be:

- "A" = the accrued benefit of $18,000 per year payable at NRA, plus
- "B" = the cash balance account based on the principal and interest credits under the cash balance plan formula.

The "B" value at the end of the first year would equal the principal credit of $3,800, based on Leah's earnings in 2009, which were $95,000 (4% of $95,000 is $3,800). In subsequent years, the $3,800 cash balance account will increase with principal and interest credits.

Principal and Interest Credit

As described above, a cash balance plan will have a "principal credit" and an "interest credit" that make up the cash balance plan formula. These credits are added to the hypothetical account balance at least on an annual basis. We will now describe the principal and interest credits.

Principal Credits

Principal Credit	A principal credit is any increase to a participant's accumulated benefit under a hybrid plan (cash balance plan) that is not an interest credit. Treas. Reg. 1.411(b)(5)-1(d)(1)(ii)(D).
Example 3- Principal Credit	Same facts as Example 2. After the conversion, the cash balance plan provides a principal credit of 4% x earnings for the plan year. Leah earned $95,000 in 2009, so her principal credit for 2009 is $3,800.
Example 4- Principal Credit	Duke's cash balance plan provides the following principal credit based on the number of years of service: • For 0 – 10 years = 3% • For 11 – 20 years = 3.5% • For 20 or more years = 4%

Interest Credit

Introduction

An interest credit is any adjustment to a participant's accumulated benefit under a hybrid plan formula that is not conditioned on current service or imputed service.

An interest credit is the hypothetical investment return (for example. earnings) each participant will receive based on the amount of their hypothetical account balance.

Treas. Reg. section 1.411(b)(5)-1(d)(1)(ii).

PPA '06 Requirement- Interest Credit Cannot Exceed Market Rate

The passing of PPA '06 legislation established standards concerning interest crediting rates in cash balance plans. Section 701 of PPA '06 states a cash balance plan fails to meet the age nondiscrimination requirements (discussed below) unless the plan terms provide that the interest crediting rate for any plan year **does not exceed the market rate of return.**

Market Rate of Return

Treas. Reg. Section 1.411(b)(5)-1(d) describes rules restricting interest credits under a hybrid plan to a market rate of return. There are proposed regulations which define "market rate of return." These regulations have not been finalized as of August, 2012. However, Treas. Reg. Section 1.411(b)(5)-1(d) provides some guidance with respect to market rate of return.

Preservation of Capital- General Rule

In order to meet the requirements for a hybrid plan, the hypothetical account balance (or an accumulated percentage of final pay) cannot be less than the sum of the principal credits. This means that if the plan's formula includes a negative interest credit, the hypothetical account balance cannot be reduced below the total sum of the principal credits that was allocated to the hypothetical account balance.

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Plan can Define Interest Credits as Various Rates

A plan can define interest credits as either:

- A fixed interest rate,
- A variable outside index,
- The IRC § 417(e)(3) rate (applicable interest rate), or
- A combination of the above.

Employer Cannot have Discretion in Determining Rates

The method for determining the interest rate must be set forth in the plan and comply with IRC section 401(a)(25). Under section 401(a)(25), the plan must state the interest rates which precludes employer discretion. In addition, the rates must be definitely determinable.

Additionally, the proposed regulations issued on October 19, 2010, provide that when a hybrid plan is terminating, a plan that contains a variable rate to determine interest credits must value benefits by using the previous 5-year average of its variable rate.

Greater of Rates

If a plan's interest credits are based on the greater of two or more different rates, the rates are not in excess of a market rate of return if each rate would comply on its own. Treas. Reg. § 1.411(b)(5)-1(d)(1)(vi).

Blended Rates of Return

Blended rates (different rates applied to different portions of a cash balance account) are not in excess of a market rate of return if each rate would comply on its own. Treas. Reg. § 1.411(b)(5)-1(d)(1)(vii).

Example 5

The Franklin Company's cash balance plan provides for a 4 percent interest credit to each participant.

This is an example of a fixed interest rate.

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Example 6

The cash balance accounts of each participant will be adjusted by the investment credit using the third segment rate.

This is an example of a variable outside index.

Example 7

The interest credit provided to each participant will be the annual yield on a 1-year Treasury Constant Maturities plus 0.5 percent.

This is an example of a variable outside index.

Safe Harbor Interest Crediting Rates

Notice 2007-6, Notice 96-8 and the final regulations provide the safe harbor interest crediting rates. These rates are deemed to be not in excess of the market rate of return if the rate is adjusted at least annually.

The interest rates and associated margins are as follows:

Standard Index	Associated Margin
Discount rate on 3-month Treasury Bills	175 basis points
Discount rate on 6-month or 12-month Treasury Bills	150 basis points
Yield on 1-year Treasury Constant Maturities	100 basis points
Yield on 2-year or 3-year Treasury Constant Maturities	50 basis points
Yield on 5-year or 7-year Treasury Constant Maturities	25 basis points
Yield on 10-year or longer Treasury Constant Maturities	0 basis points
Annual rate of change in the Consumer Price Index	3 percentage points
First, second, and third segment rates (added by the 2010 final regulations).	0 basis points

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Interest Credit, Continued

Safe Harbor Interest Crediting Rates (continued)

For example, if the discount rate on 3-month Treasury bills in a given year is 3.00%, a plan could calculate interest credits for that year using a rate of 3.00% plus 1.75% = 4.75% (which would be considered a safe harbor rate). Such a rate would not be considered to exceed the market rate of return.

Calculating the Hypothetical Account Balance

Introduction

Now that we have defined hypothetical accounts, principal credits and interest credits, we can now illustrate how to calculate the balance of hypothetical accounts. As described above, hypothetical accounts may start with an opening balance if:

- The cash balance plan was converted from a traditional DB plan, and
- The accrued benefit immediately before the conversion was converted to the present value of that benefit.

Example 8- Conversion with an Opening Balance

Same facts as Example 1. Dade Company sponsors a traditional defined benefit plan. Leah had an accrued benefit on December 31, 2008 of $18,000 payable annually for life starting at normal retirement age.

On January 1, 2009, the DB plan was converted to a cash balance plan. The plan sponsor converts Leah's accrued benefit to the present value, which becomes the opening balance of the hypothetical account. Assume the present value of the $18,000 annuity at Leah's NRA is $102,000. This amount becomes the opening balance of the hypothetical account. Remember that upon distribution, the opening balance will need to be checked to make sure that the section 417(e) assumptions were properly applied.

Assume the interest credit is 5% of the account balance and the principal credit is 4% of plan year earnings. Leah's hypothetical account is the following:

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Calculating the Hypothetical Account Balance, Continued

Table I-calculating the hypothetical account balance for 2009

1.	Opening hypothetical account balance as of January 1, 2009	$102,000
2.	Interest credit at 5% (5% x $102,000), which is credited at the end of the year	$5,100
3	Principal credit at 4% of pay (4% x $95,000) (credited at the end of the year)	$3,800
4	Hypothetical account balance account at end of 2009 (1+2+3)	$110,900

Determining the Accrued Benefit of a Cash Balance Plan

Accrued Benefits under Cash Balance Plans

Traditional DB plans define a participant's accrued benefit as an amount payable in a certain form (*for example*, single life annuity) starting at a certain point (*for example*, at normal retirement age).

Because a cash balance plan is a DB plan, the cash balance plan is required to provide annuity benefits for those participants who do not elect another form of payment. These annuity benefits are generally calculated as the actuarial equivalent of the participant's cash balance hypothetical account, based on actuarial assumptions defined in the plan. The annuity is also important when determining the default Joint and Survivor (J&S) form of payment.

Determining the Accrued Benefit

The accrued benefit at normal retirement age is generally calculated by:

- Projecting the participant's hypothetical account balance with interest to normal retirement date, and then
- Converting the result to a lifetime annuity by dividing by a present value factor.

The interest rate and mortality rate used to project the hypothetical account balance and to calculate the present value factor must be specified in the plan document. The IRS has taken the position that the hypothetical account balance must be projected to normal retirement date using the interest crediting rate in effect on the date the projection is made.

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Determining the Accrued Benefit of a Cash Balance Plan, Continued

Example 9- Determining Leah's Accrued Benefit at the end of 2009- Plan Assumptions

Same facts as example 8. At the end of 2009, Leah is now age 51.

The calculation of the accrued benefit is as follows:

- Normal retirement age = 65
- Interest crediting rate = 5% per year
- Plan's annuity purchase rate at age 65 = 11.8[1]
- Leah's age = 51 (14 years to normal retirement)
- Leah's hypothetical account balance = $110,900

First Step- Project the Hypothetical Account Balance

Leah's accrued benefit is calculated by first projecting the hypothetical account balance to normal retirement age at the interest crediting rate:

$\$110{,}900 \times (1.05)^{14} = \$219{,}574$

Next Step- Divide by the Annuity Purchase Rate

The next step is to divide by the age 65 annuity purchase rate:

$219,574 / 11.8 = $18,608 per year, equals the accrued benefit payable annually at normal retirement age.

Conclusion

As you can see from this example, the accrued benefit has increased $608 over the one year period (from $18,000 to $18,608).

[1] The Annuity Purchase Rate is the amount it would cost to provide a $1.00 annual benefit for life based on a given interest rate, mortality table, and age.

Age Discrimination Issues

Introduction

A DB plan does not satisfy the accrued benefit requirement of section 411(b) if, under the plan, an employee's benefit accrual stops or the rate of benefit accrual is reduced because of the attainment of any age (section 411(b)(1)(H)(i)). Prior to PPA '06, cash balance plans were accused of violating the age discrimination requirement.

PPA '06 Changes with Respect to Age Discrimination

PPA '06 addresses the age discrimination requirement by providing that a cash balance formula does not discriminate on the basis of age **if**:

- Interest credits are no larger than a market rate of return, (as provided in section 1.411(b)(5)-1(d) of the regulations (covered above), and
- The accrued benefit for an older participant is not less than the benefit for a similarly-situated younger participant.

  For this purpose, accrued benefit can be defined as an annuity at NRA, the account balance under a cash balance plan, or the accumulated percentage of final average compensation under a PEP plan. When testing for similarly situated employees, the final regulations uses "accumulated benefit" instead of "accrued benefit." Accumulated benefit means the "benefit accrued to date," or can be expressed as the balance of the hypothetical account. Treas. Reg. Section 1.411(b)(5)-1(b)(1).

Similarly Situated

The regulations define similarly situated as any individual is identical to any other individual in every respect that is relevant for determining a participant's benefit under the plan (including period of service, compensation, position, date of hire, work history, and any other respect) **except for age**.

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Age Discrimination Issues, Continued

Example 10

For example, if the plan defined the accumulated benefit as the greater of two benefits only for participants younger than age 55, and participants age 55 and older would only receive one benefit, this would **not** meet the similarly situated requirements.

Effective Date

For plans that were in existence on June 29, 2005, this provision generally applies to years beginning after December 31, 2007 (later for collectively bargained plans). A plan sponsor can elect to apply these provisions as early as June 29, 2005.

Determining the Present Value of the Accrued Benefit under a Cash Balance Plan

Introduction

Now that we know how to calculate the accrued benefit using the hypothetical account balance, we can now discuss another PPA '06 requirement: the 417(e) requirement when calculating the present value of the accrued benefit for cash balance plans. As calculated above, participant's hypothetical account was converted to the accrued benefit at NRA.

Since cash balance plans are defined benefit plans, a participant may receive a lump sum based on the based on the **present value of the accrued benefit payable at NRA.** To determine this present value amount, prior to PPA '06, a plan sponsor had to use the 417(e) specified interest and mortality assumptions. Depending on the assumptions used under the cash balance plan, the present value of the annuity at NRA could differ from the hypothetical account balance.

PPA'06 417(e) Requirements

PPA '06 addressed the 417(e) requirement by adding IRC section 411(a)(13). Thus, for a cash balance plan, the present value of the accrued benefit **is equal** to the hypothetical account, and the 417(e) requirements are deemed to be satisfied. By equating the hypothetical account with the present value of the accrued benefit, the requirements under section 417(e) are satisfied without the need to specifically apply the 417(e) assumptions to determine the present value of the accrued benefit.

As explained below, PPA '06 also added a new vesting requirement, which is 100% vesting after three years.

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Determining the Present Value of the Accrued Benefit under a Cash Balance Plan, Continued

Plan Language that Provided for Section 417(e)-411(d)(6) Relief

Under PPA '06, hybrid plans are deemed to satisfy section 417(e). Section 411(a)(13)(A). Prior to PPA '06, a hybrid plan was required to apply the 417(e) assumptions, resulting in a higher hypothetical account balance if the interest crediting rate exceeded the 417(e) rate. (For more information, see whipsaw discussion below).

Under Notice 2007-6, if a plan provided for the 417(e) assumptions in calculating the single sum distributions (instead of using the hypothetical account balance), this language can be deleted from the plan without violating the anti-cutback rule under IRC section 411(d)(6). Thus, for a cash balance plan providing for a single sum distribution based on the 417(e) rates, which results in the distribution exceeding the hypothetical account balance, the plan may be amended to eliminate the excess for distributions made after August 17, 2006. See section 1107 of PPA '06 (covered below) and Part III(B)(3) (Transitional Guidance) of Notice 2007-6.

Lump Sum Based Plan

For purposes of Notice 2007-6, the term lump sum based plan means a defined benefit plan under the terms of which the accumulated benefit of a participant is expressed as the balance of a hypothetical account maintained for the participant or as the current value of the accumulated percentage of the participant's final average compensation, and includes a plan under which the accrued benefit under the terms of the plan is calculated as the actuarial equivalent of such a hypothetical account balance or accumulated percentage.

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Vesting for Cash Balance Plans

Vesting

Section 701(b)(2) of PPA added IRC § 411(a)(13) which provides a special vesting requirement for hybrid plans. Hybrid plans must provide for 100 percent vesting of employer contributions after three years of service.

Treas. Reg. § 1.411(a)(13)-1(c)(1) provides that this vesting requirement would apply even if a portion of the benefit is not determined under a hybrid benefit formula.

Timing of Plan Amendments

Notice 2011-85 – Most Current Extensions

This notice extended the effective/applicability date of the provisions under 1.411(b)(5)-1(d) to plan years beginning on or after January 1, 2012. Section 1.411(b)(5)-1(d) provides the rules under section 411(b)(5)(B)(i), which is the requirement that a hybrid plan's interest crediting rate cannot exceed the market rate of return. Section III of Notice 2011-85 provides that with respect to the interest crediting rates, the proposed hybrid regulations, when finalized, will apply for plan years that begin on or after a date to be specified in those regulations. However, the final regulations will not apply earlier than for plan years beginning after January 1, 2013.

Extensions under Section 411(a)(13) and 411(b)(5)

Part IV of Notice 2011-85 also extends the deadline for adopting an interim or discretionary plan amendments under section 411(a)(13) and 411(b)(5), except for section 411(a)(13)(A). The deadline for adopting an interim or discretionary plan amendment under section 411(a)(13) and section 411(b)(5) is extended to the last day of the first plan year preceding the plan year for which the 2010 proposed hybrid regulations, once finalized, apply to the plan.

The requirements under Section 411(a)(13) and 411(b)(5) that have been extended includes:

- The minimum vesting requirement, 100% vesting after three years of service,
- The similarly situated requirement,
- The preservation of capital requirement, and
- The "A plus B" method.

A plan must continue to satisfy the operational compliance requirements of section 1107 of PPA '06 as a condition of the deadline extension for adopting plan amendments provided by Notice 2011-85.

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Timing of Plan Amendments, Continued

Section 411(a)(13)(A)-Not Extended

The requirement allows a hybrid plan to provide that the present value of the accrued benefit of any participant is equal to the balance of the hypothetical account. This requirement was covered above.

This change was not extended, and was effective under the general PPA '06 date. Thus, under section 1107 of PPA '06, the amendment must be adopted no later than the last day of the plan year beginning after January 1, 2009.

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IRC Section 401(a)(4) Nondiscrimination Requirements

Introduction

As with all DB plans, a cash balance plan can satisfy the nondiscrimination requirements under Treas. Reg. Section 1.401(a)(4) by applying one of the following three alternatives:

- Satisfying the safe harbor requirements,
- Satisfying the non-designed based safe harbor, or
- Satisfying the general test.

Requirements-Safe Harbor

A safe harbor plan means that the plan provisions satisfy the nondiscrimination requirements without any numerical testing. A plan can satisfy the safe harbor under Treas. Reg. section 1.401(a)(4)-8(c)(3) under a uniform allocation that is the same percentage of plan year compensation or the same dollar amount. The safe harbor requirements refer to the requirements under Treas. Reg. section 1.401(a)(4), which were issued in 1994. These requirements are distinct from the "safe harbor" requirements for hybrid plans under section 411(a)(13) and 411(b)(5).

Safe Harbor under Treas. Reg. Section 1.401(a)(4)-8(c)(3)

A cash balance plan must satisfy numerous requirements in order to be a safe harbor plan for nondiscrimination purposes. Some of those requirements include:

- A uniform allocation formula which is applied to all employees under the plan in either a uniform percentage of compensation or a uniform dollar amount (permitted disparity can be used),
- A frontloaded interest crediting mechanism,
- An interest credit which is a single rate specified in the plan, a permissible variable rate based on the US Treasury Bills or the Treasury Constant Maturities (the variable interest rate must be one of the following: rate on a 3-month, 6-month, or 1-year Treasury Bills, yield on a 1-year, 2-year, 5-year, 10-year, or 30 year Treasury Constant Maturities, and the same interest rate must be applied to all employees), and

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IRC Section 401(a)(4) Nondiscrimination Requirements,
Continued

Safe Harbor under Treas. Reg. Section 1.401(a)(4)-8(c)(3) (continued)

- Interest adjustments to the hypothetical allocations must be provided through NRA stated in the plan, even if the employee terminates employment or commences benefits before that age.

Interest adjustments to the hypothetical allocations must not be conditioned on the employee's satisfaction of any requirement (such as last day requirement or future service),

Modified Safe Harbor

Additionally, a plan may use the modified general test safe harbor (non-designed based safe harbor) which requires annual comparison of hypothetical allocations under the plan between HCEs and NHCEs and under this formula, permitted disparity may be imputed.

General Test

If the plan does not satisfy the provisions above, then it must satisfy the general test. Generally, most plans pass section 401(a)(4) under this method since most plans do not satisfy the uniformity requirements for a safe harbor.

Other Requirements for Cash Balance Plans

Other Requirements Relevant to Hybrid Plans

A hybrid plan is still subject to the provisions of traditional defined benefit plans. Some of these items are included in the list below. Since all of these items were covered in prior training material (Phases 1A, B, and C), they will not be covered in this chapter.

- IRC § 401(a)(11) and 417(a) – Distribution requirements
- IRC § 410(b) – Coverage
- IRC § 411(a)(8) – Reasonable NRA
- IRC § 412 – Minimum funding requirements (pre-2008 plan years)
- IRC § 415(b) – Limitations and Adjustments
- IRC § 416 – Top Heavy Requirements
- IRC Sections 412 and 430 – Minimum funding requirements (post -2008 plan years)

Processing Implications for Moratorium Plans

The IRS issued Notice 2007-6, which provides preliminary guidance as to how moratorium cash balance plans have been processed. This notice states that the IRS will not review whether a plan conversion before June 30, 2005, satisfies the age discrimination requirements under IRC section 411(b)(1)(H). Therefore, determination letters issued on these plans do not consider, and may not be relied upon with respect to, whether the conversion meets these requirements.

No special caveat will be used for moratorium plans. Notice 2007-6 will effectively provide a general caveat with respect to the plan sponsor's inability to rely on the determination letter with respect to age discrimination issues relating to the conversion.

For plan conversions adopted and effective after June 29, 2005, the plan amendment must follow the requirements outlined in PPA '06. A plan sponsor may elect to apply these provisions to plan amendments adopted before and taking effect after June 29, 2005.

IRC Section 411(b) Accrual Rules-Overview

Accrual Rules for Cash Balance Plans

As with any DB plan, a cash balance plan must meet one of the three minimum accrual requirements under IRC 411(b):

- The 3% accrual rule,
- The fractional accrual rule, or
- The 133 1/3% accrual rule.

Generally, most cash balance plans will only pass the 133 1/3% accrual rule. Under this rule, the rate of benefit accrual is the increase in the participant's accrued normal retirement benefit for the plan year, including any benefit attributable to interest credits.

133 1/3% Rule

The 133 1/3% rule requires that:

- The accrued benefit payable at normal retirement age is equal to the normal retirement benefit, and
- The annual rate of accrual for any participant who is **or could be** a participant for any **later** plan year cannot be more than 133 1/3% of the rates of accrual for any **earlier** plan year.

Changes Disregarded

In applying the 133 1/3% rule:

- Treat any plan amendment in effect for the current year as if it has always been in effect.
- Disregard any change in an accrual rate that does not apply to any individual who is or could be a participant in the current year.
- Ignore any provisions that take effect in future years.
- Ignore early retirement benefits and early retirement subsidies.
- Treat Social Security benefits and all other relevant factors (discussed below) used to compute benefit for the current year as remaining constant for all future years.

Continued on next page

IRC Section 411(b) Accrual Rules-Overview, Continued

Changes Disregarded (continued)

Note: The 133 1/3% rule only tests rates of accrual for the current year and future years and is not applied using the actual dollar amount of accruals. The rates are viewed as a percentage of pay and are based on the interest rate for the current year.

Cash Balance Plans with Steps or Levels

The accrual requirements for cash balance plans are a requirement that plan designers sometimes overlook. When the plan's allocation formula includes steps or levels, the exam agent should document compliance with section 411(b), which may involve a request for a demonstration that the plan satisfies the accrual requirements.

Relevant Factors under 133 1/3% Rule

Social Security benefits and all other relevant factors used to compute benefits are treated as remaining constant as of the current year and for all future years.

For hybrid plans, these factors include interest rates, APRs and participant categories. For participant categories, if there are different cash balance formulas for hourly versus salaried participants, an hourly participant is assumed to continue in hourly status for all future years.

Continued on next page

Example 11 Illustrating Traditional DB Plan Failing the 133 1/3% Rule

Applying the 133 1/3% rule to a traditional DB plan.

Consider a plan with the following formula:

1.0% of compensation times service up to 10 years, plus

1.2% of compensation times service from 10 to 20 years, plus

1.5% of compensation times service over 20 years.

This plan does not meet the accrual rules because 1.0% times 133 1/3% is 1.333%, so the maximum accrual rate for any year after 10 years of service is 1.333%. The rate for service over 20 years is 1.5%, which is more than this maximum, and so the formula is backloaded.

Note: this fails even though each step of the formula increases to less than 133 1/3% of the previous step:

1.2% is less than 133 1/3% of 1.0%

1.5% is less than 133 1/3% of 1.2%

Application of 133 1/3% Rule to Cash Balance Plans

Introduction

As with all DB plans, the 133 1/3% rule is applied to the accrued benefit payable at normal retirement age. This benefit is determined according to plan's terms, using the plan's rates for projecting the account balance to normal retirement age and then converting the resulting amount to an annuity benefit starting at normal retirement age.

133 1/3% Rule Must Work for Everyone

The 133 1/3% accrual rule must work for anyone who is **or who could become** a participant. This means that the cash balance formula must work for all ages, even for ages not applicable to current participants.

The cash balance accrual would be tested by comparing the accrued benefits payable at normal retirement age purchased by the principal credit at each age, using the plan's terms.

If the Formula Does Not Work for One Participant

Only one counterexample is needed. If the plan's accrual formula will not work for any one participant at any age, under any possible scenario, the plan does not meet the accrual rule.

Do Not Take into Account Increases in Compensation or Interest

The actual increase in a participant's accrued benefit to reflect changes in compensation or interest credits are not considered when determining if the plan satisfies the 133 1/3% rule.

If the dollar amount of a participant's actual accrual for a given year is more than 133 1/3% of the dollar amount of his or her accrual in a previous year because of a pay raise or an increase in the interest rate, this does not necessarily mean the plan is backloaded.

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Frontloaded versus Backloaded Interest Credits

In a cash balance plan, how interest is credited is very important in determining whether or not the plan complies with the 133 1/3% rule.

If the plan provides that future interest credits are **not** conditioned on future service, it means that a participant earns the right to all future interest credits on a particular cash balance principal credit at the same time that he or she earns that principal credit, whether or not the participant leaves the employer. Under this approach, the plan provides for frontloaded interest credits.

A plan with backloaded interest credits conditions all or part of future interest credits on continuing service with the plan sponsor. For instance, a plan that credits interest at a rate of 6% per year for active employees and 4% per year for terminated employees is backloaded with respect to the 2% difference between the interest rates for active and terminated employees.

Future Interest Credits Conditioned on Future Service-Backloading

If future interest credits are conditioned on future service, then those interest credits must be counted as an accrual in the year they are credited. A plan with this feature would find it virtually impossible to comply with the 133 1/3% accrual rule.

Determining the Accrued Benefit

If the plan frontloads the interest credits, future interest credits are included in current accruals. This means that the accrued benefit purchased by the plan's principal credits at normal retirement age is calculated by:

- Determining the principal credit at each age,
- Projecting each principal credit with interest to normal retirement age, using the plan's interest crediting rate, and
- Converting the projected amount to an annuity payable at normal retirement age using the plan's actuarial equivalent factors to convert a hypothetical account balance to an annuity.

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Application of 133 1/3% Rule to Cash Balance Plans,
Continued

Compare the Annuities

Once the annuities are determined at each age, they are compared to determine whether the 133 1/3% test is satisfied. In other words, if one of the annuities is more than 133 1/3% of an earlier annuity, the plan fails the 133 1/3% test.

Example 12 Illustrating a Front Loaded Cash Balance Plans

Applying the 133 1/3% rule to a cash balance plan with frontloaded interest credits:

Facts:

- Plan eligibility = age 21
- Annual principal credit = $500
- Interest crediting rate = 5% per year
- Normal retirement age = 65
- Annuity purchase rate at age 65 = 10.0

Example 12 Calculating the Annuities

The principal credit of $500 is credited with 5% interest under the plan to normal retirement age to determine the lump sum amount available for purchasing an annuity. For a 21 year old participant, the interest credited for 44 years is:

$\$500 \times 1.05^{44}$ or $4,279.

The lump sum is then divided by the Annuity Purchase Rate (APR) to determine the amount of the annuity. If the APR is 10, $4,279/10 is $427.86.

This calculation is performed for all ages, from 21-65, to see if the accruals satisfy the 133 1/3% test.

The table below calculates the accrual for each age at normal retirement age (NRA).

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Application of 133 1/3% Rule to Cash Balance Plans,
Continued

Table calculating the annuities

Age	Principal Credit	Years to NRA	Projected Principal Credit	Annuity Purchase Rate	Accrual at NRA
21	$500	44	$4,279	10.00	$427.86
22	$500	43	$4,075	10.00	$407.48
23	$500	42	$3,881	10.00	$388.08
: :	: :	: :	: :	: :	: :
62	$500	3	$579	10.00	$57.88
63	$500	2	$551	10.00	$55.13
64	$500	1	$525	10.00	$52.50
65	$500	0	$500	10.00	$50.00

Example 12-Conclusion

Since the accruals steadily decrease over a participant's career, none of the future accruals are more than 133 1/3% of any earlier accruals. Thus, this plan complies with the 133 1/3% accrual rule.

Varying Interest Credits

Some plans may provide interest credits that vary by service. For example,

- For 0 – 10 years = 3%
- For 11 – 20 years = 4%
- For 20 or more years = 5%

The projected principal credit at normal retirement date would take into consideration the higher interest crediting rates for future service. For example, a newly hired 30 year old employee with 35 years of service at NRA would project the principal credit for 10 years at 3%, 10 years at 4% and 15 years at 5%.

Pension Equity Plans (PEPs)

Overview

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Another category of a hybrid plan is a pension equity plan (PEP). A PEP is similar to a cash balance plan in that the participant's benefit is expressed as a lump sum (not because the plan has a lump sum payment option). However, this type of plan generally does not have hypothetical accounts or hypothetical allocations. Instead, the accumulated benefit is defined in terms of the current value of an accumulated percentage of the participant's final average compensation.

Benefit Formulas in PEPs

Generally, the benefit formula in a PEP is similar to formulas found in traditional DB plans stating that the benefit is an accumulated percentage of final pay, with the percentage determined on the basis of points received for each year of service. The points are often weighted for older or longer service employees.

PEPs frequently provide interest credits for the period between a participant's termination of employment and when the benefit commences. Some PEPs:

- Never credit interest, directly or indirectly,
- Explicitly credit interest after cessation of PEP accruals, or
- Provide for specific amounts to be payable after cessation of accruals (both immediately and at future dates) based upon the actuarial equivalence using specified actuarial factors applied after cessation of accruals.

Market Rate of Interest

The final regulations issued on October 18, 2010, provide that if a plan does provide interest credits for the period between a participant's termination of employment and when the benefit commences, the market rate of interest rules apply.

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Example 13

A simple example of a PEP plan formula is one that provides for a lump sum percentage equal to 10% per year of service multiplied by final average compensation. A participant retires with 20 years of service and final average compensation of $100,000. Assume the APR is 11.

- The lump sum would be 20 x 10% x $100,000 or $200,000.
- The annuity would be $200,000/11 or $18,182 per year.

Example 14-Facts

A PEP plan had the following formula:

Age at which benefit is earned	Applicable lump sum percentage per year
Under 30	6%
30-34	7%
35-39	8%
40-44	10%
45-49	12%
50-54	15%
55 and older	20%

Continued on next page

Example 14- Employee

The following table illustrates the lump sum benefit of an employee who was hired at 30 and retired at 65. Final average compensation is $100,000:

Age at which benefit is earned	Applicable lump sum percentage per year	Years of service	Percentage of final average comp
Under 30	6%	0%	
30-34	7%	5 years x 7%	35%
35-39	8%	5 years x 8%	40%
40-44	10%	5 years x 10%	50%
45-49	12%	5 years x 12%	60%
50-54	15%	5 years x 15%	75%
55 and older	20%	10 years x 20%	200%
Total			460%
Total lump sum			460% x $100,000 or $460,000

Example 15 - Facts

A PEP plan had the following formula:

Age at which benefit is earned	Applicable lump sum percentage per month	Applicable lump sum percentage per year
Under 30	1/6%	2%
30-34	1/3%	4%
35-39	1/2%	6%
40-44	2/3%	8%
45-49	1%	12%
50-54	1 1/3%	16%
55 and older	1 1/2%	18%

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Pension Equity Plans (PEPs), Continued

Example 15-Employee

Based on the prior formula, a participant was hired at 42 and terminated service at 52. This participant's final average compensation was $100,000:

Age at which benefit is earned	Applicable lump sum percentage per year	Years of service	Lump sum percentage
Under 30	2%		
30-34	4%	0	0%
35-39	6%	0	0%
40-44	8%	3	24%
45-49	12%	5	60%
50-54	16%	2	32%
55 and older	18%	0	0%
Total			116%
Total lump sum			116% x $100,000 = $116,000

PEP Guidance

As of the publication of this material, there is very little guidance on PEPs. Notice 2007-6 requested comments on qualification requirements applicable to these types of plans and the proposed regulations issued on December 28, 2007, stated that the Service was evaluating PEP issues. The final regulations issued in 2010 provided basic definitions, vesting and a safe harbor provision for age discrimination issues.

Comments received from the public in the past expressed that there is little or no guidance on these plans and that a comprehensive set of rules needs to be prepared in order to provide a clear path to compliance.

Controversies Surrounding Cash Balance Plans

Introduction

Cash balance plans have experienced a great deal of negative publicity. Much of the negative publicity has to do with traditional DB plans that were converted to cash balance plans. In some cases, participants were unhappy because the conversion decreased future benefit accruals.

There was also a great deal of concern regarding whether employees understood the differences between their traditional plan and the new cash balance plan. In addition, there was concern about the impact on older employees in particular.

This section and the sections that follow discuss the background of cash balance plans and how PPA '06 addressed specific issues relating to cash balance and PEP plans. Note that the current rules under PPA '06 were discussed above.

Litigation Issues

Several controversial issues have been raised in court proceedings concerning the conversion of traditional defined benefit plans to cash balance plans. Three of the key issues raised include wear away, age discrimination, and whipsaw:

- Whether lump sums paid from a cash balance plan comply with the minimum present value requirements of section 417(e). This is the whipsaw issue.
- Whether a cash balance plan discriminates against older workers. This is the age discrimination issue.
- Whether the plan's method of converting from a traditional DB plan to a cash balance plan complies with applicable rules. This is the wear away issue.

Continued on next page

IRS Responses

Due to the controversies surrounding cash balance plans the IRS suspended processing of cash balance conversions pending resolution by Congress:

- A 1999 field directive required that all cash balance conversions be submitted to the National Office for technical advice.
- Notice 96-8 was issued to address whipsaw issues.
- The IRS and Treasury issued proposed regulations in 2002, which were subsequently withdrawn.
- Announcement 2003-1 established a moratorium on processing determination letters for all cash balance conversions, pending the issuance of regulations on age discrimination issues.
- The IRS and Treasury again issued proposed regulations in 2007. Parts of these regulations were issued as final regulations in 2010 with another part reissued again as proposed additional regulations.

Section 417(e) and Whipsaw issue

Introduction

One of the litigation issues that was addressed by PPA '06 is the whipsaw issue.

Whipsaw Potential

One of the key technical issues was that plan sponsors wanted to pay the lump sum value equal to the hypothetical account balance.

Since cash balance plans are defined benefit plans, the lump sum is determined based on the present value of the accrued benefit payable at normal retirement age. Prior to PPA '06, the present value of the accrued benefit was based on 417(e) specified interest and mortality assumptions. These assumptions, when applied to the accrued benefit at normal retirement age, may not equal the hypothetical account balance.

Whipsaw occurs when the interest crediting rate in determining a participant's hypothetical account balance **is higher** than the interest rate used to determine the present value of the annuity beginning at normal retirement age under section 417(e).

Example 16

Brown Company sponsors a cash balance plan, which has an interest crediting rate of 6%. The 417(e) interest assumption is 4%, and the APR is 10.0.

Adam had a hypothetical account balance of $150,000. He is 45 years old and decides to leave the company. Using an interest crediting assumption of 6% and an APR of 10.0, the accrued benefit at NRA is $48,107.

The accrued benefit was calculated as follows;

- First project the hypothetical account balance to normal retirement age:
  - $\$150{,}000 \times (1.06)^{20} = \$481{,}070$
- Second divide by the age 65 annuity purchase rate:
  - $481,070 / 10 = $48,107 per year

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Section 417(e) and Whipsaw issue, Continued

Example 16-Present Value Using 417(e) Assumptions

Assume section 417(e) assumptions are required to be used to determine the present value of Adam's accrued benefit.

- The first step is to determine the present value of the accrued benefit at age 65.
    - The accrued benefit would be multiplied by the APR, of 10.0.
    - The present value of the accrued benefit at age 65 would be $481,070.
- The next step is to discount the present value at age 65 using the 417(e) interest rate of **4%**, (not the interest crediting rate of 6%) back to Adam's current age.
- To discount the present value of the accrued benefit, the present value has to be divided by the interest assumption of 4%:
    - The present value would be $219,554 or ($481,070/$\mathbf{1.04^{20}}$).

Whipsaw Occurred

The minimum present value (and thus the minimum lump sum payment provided by the plan) is $219,554.

Therefore, if this participant elects to take a lump sum distribution, the plan must pay at least $219,554 even though the hypothetical account balance was only $150,000. This effect is known as whipsaw.

PPA'06 Eliminates Whipsaw

As covered above, IRC section 411(a)(13) provides that the present value of the accrued benefit under a cash balance plan is equal to the hypothetical account. Thus, a cash balance plan is no longer required to use section 417(e) assumptions when determining the lump sum value of a cash balance annuity. With this change, whipsaw is eliminated.

Therefore, in the example above, the cash balance account of $150,000 would be payable.

Age Discrimination

Introduction

Cash balance plans have been subject to claims that they discriminate against older workers.

Age Discrimination Claims – Ongoing Cash Balance Formulas

As discussed earlier, the accrued benefit under a cash balance plan is typically determined by projecting the hypothetical account balance with interest to normal retirement, and then converting the result to an annuity payable at normal retirement.

Because a younger employee has more years to earn interest on the cash balance account, a given principal credit buys a larger normal retirement benefit for a younger employee than it will for an older employee.

Example 17

For example, consider a cash balance plan with the following provisions:

- Normal retirement age = 65
- Annual principal credit = $500
- Interest crediting rate = 5% per year
- Annuity purchase rate at normal retirement age = 10.0

In this plan, every participant is entitled to a principal credit of $500 each year. However, the $500 principal credit provides an annual normal retirement annuity benefit of $352 for a 25-year old – and only $50 for a 65-year old:

Participant-Age 25

Participant age 25 (40 years to normal retirement):

Age 65 benefit = $500 x $(1.05)^{40}$ / 10.0 = $352

Participant - Age 65

Participant age 65 (zero years to normal retirement):

Age 65 benefit = $500 x $(1.05)^{0}$ / 10.0 = $50

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Age Discrimination, Continued

Conclusion

Some have seen this as discriminatory, because the older worker earns or accrues a smaller increase in his or her normal retirement annuity, in this case about 1/7 as much.

PPA '06 Changes Resolved Age Discrimination

PPA '06 provides that a cash balance formula does not discriminate on the basis of age **if**:

- Interest credits are no larger than a market rate of return, (as provided in section 1.411(b)(5)-1(d) of the regulations), and
- The accrued benefit for an older participant is not less than the benefit for a similarly-situated younger participant.

The regulations define similarly situated as any individual is identical to any other individual in every respect that is relevant for determining a participant's benefit under the plan (including period of service, compensation, position, date of hire, work history, and any other respect) except for age.

Note that the similarly situated and the market rate rules were covered above.

Age Discrimination-Wear Away

Other Age Discrimination Issues-IRC Section 411(b)(1)(H)(i)

Qualified plans are not permitted to provide for benefits or allocations that decrease because of age. For defined benefit plans, IRC section 411(b)(1)(H)(i) specifies that a DB plan violates this requirement if under the plan, an employee's benefit accrual is ceased or the rate of an employee's benefit accrual is reduced, because of the attainment of any age.

Claims have been made that cash balance plans violate this rule based on:

- The methods used by some plans to convert from a traditional DB benefit plan, and
- The conversion of ongoing principal and interest credits to an annuity benefit payable at normal retirement age.

Wear Away Conversion Approach

Some plans converted from a traditional DB plan to a cash balance plan using a wear-away approach.

In its simplest form, this approach compares the frozen benefit accrued under the prior plan formula with the accrued benefit earned under the cash balance formula. In these cases, the cash balance formula generally has a starting account balance based on the present value of the frozen accrued benefit under the prior plan formula.

This meets the requirements of IRC § 411(d)(6), which requires that an amendment cannot reduce the accrued benefit already earned by a participant.

Result of Wear Away Approach

The result of this approach can be that the participant does not earn any additional benefits until the cash balance accrued benefit catches up to the frozen prior-formula accrued benefit.

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Age Discrimination-Wear Away, Continued

Age Discrimination Claims – Wear Away Conversions

Although wear-away conversions protect the benefit already earned before the amendment as required under IRC 411(d)(6), the wear-away period tends to be longer for older participants than for younger participants:

- Older participants tend to have longer service, so the benefits they accrued prior to the date of the amendment tend to be larger than for younger employees.
- Older participants do not have as many years remaining before normal retirement, so they do not have as much time to accumulate interest credits on the cash balance hypothetical account.
- Early retirement subsidies tend to be more significant for older participants, because a larger portion of their benefit is provided under the prior plan formula.

PPA '06 Changes

As previously mentioned, for conversions after June 29, 2005, PPA '06 provides that the conversion from a traditional DB plan to a cash balance plan does not discriminate with respect to age if:

- A participant's benefit is no less than the frozen benefit under the plan, plus future cash balance benefits ("A plus B" approach), and
- Early retirement subsidies on prior-formula benefits are included in the frozen prior-formula benefit if the participant is eligible for a subsidy when he or she actually retires.

Summary

Key Points

- Cash balance plans contain features such as hypothetical accounts, allocations, interest and principal credits..
- For a traditional DB plan converting into cash balance plan, a minimum benefit equal to the "A plus B" method must be provided. The A plus B method freezes the participant's accrued benefit prior to the conversion and then adds to the hypothetical account balance immediately after the conversion.
- The accumulated benefit is the current balance of the hypothetical account.
- A hypothetical account grows with interest and principal credits. These credits make up the formula.
- A principal credit is a credit that is usually a flat dollar amount or based on the participant's pay for the plan year.
- For the interest credit standards, the plan has to meet the market rate of return and the preservation of capital requirements. Thus, the interest rate cannot exceed the market rate of return. If there is negative interest, the hypothetical account cannot be reduced below the sum of the principal credits.
- The hypothetical account is equal to the present value of the accrued benefit, automatically satisfying the IRC section 417(e) requirement and eliminating whipsaw.
- The plan must meet the similarly situated requirement with respect to the accrued benefit.
- Hybrid plans must provide a three-year 100% vesting schedule.
- Cash balance plans are subject to the accrual rules under IRC section 411(b) and generally will only pass the 133⅓ % method.
- Cash balance plans must satisfy the nondiscrimination requirements under section 401(a)(4).

Reference Materials

Reference Materials

- IRC § 401(a)(4) and the applicable regulations
- IRC § 401(a)(11) and the applicable regulations
- IRC § 401(a)(25) and the applicable regulations
- IRC § 410(b) and the applicable regulations
- IRC § 411 and the applicable regulations
- IRC § 412 and the applicable regulations
- IRC § 414 and the applicable regulations
- IRC § 415(b) and the applicable regulations
- IRC § 416 and the applicable regulations
- IRC § 417 and the applicable regulations
- IRC § 430 and the applicable regulations
- Announcement 2003-1
- Announcement 2004-57
- Announcement 2009-82
- Notice 96-8
- Notice 2007-6
- Notice 2008-85
- Notice 2009-97
- Notice 2010-77
- Notice 2011-85
- Pension Protection Act of 2006 (PPA '06)
- Rev. Rul. 2007-67
- Section 1.401(a) (4)-8(c)
- *Eaton* v. *Onan Corporation*, 117 F.Supp. 2d 812 (S.D.Ind. 2000)
- *Register* v. *PNC Financial Services Group Inc.*, 477 F.3d 56 (3rd Cir. 2007)

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Reference Materials (continued)

- *Campbell* v. *BankBoston, N.A.*, 327 F.3d 1 (30 EBC 1001) (1st Cir. 2003)
- *Berger* v. *Xerox Corp. Retirement Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003)
- *Esden* v. *Bank of 6 Boston*, 229 F.3d 154 (2d Cir. 2000)
- *Lyons* v. *Georgia-Pacific Corp. Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000)
- *Cooper* v. *IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. III. 2003)