What is a Cash Balance Plan?

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What is a Cash Balance Plan?

A cash balance plan is a defined benefit plan that calculates benefits in a manner similar to defined contribution plans. It resembles a defined contribution plan in that each employee has a hypothetical account or "cash balance" to which contributions and interest payments are credited; however, since the actual funds are pooled, directed investing is not available. As with other defined benefit plans, the employer bears both the risk and the benefits of investment performance.

The Pension Protection Act of 2006 ended a long period of uncertainty (at least prospectively) for cash balance plans, by amending the Internal Revenue Code, ERISA and the Age Discrimination in Employment Act of 1967 to provide that such plans will not be age discriminatory if certain requirements are met. A preexisting IRC requirement under which cash balance plans had been attacked states that an employee's benefit accruals may not cease, and the rate accrual may not be reduced, because of the attainment of any age.[1] Three parallel amendments provide that a plan will not be treated as failing this requirement if a participant's accrued benefit, determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant. [2] Except as otherwise indicated below, the provisions of PPA 2006 are effective for periods after June 28, 2005.[3]

A participant is "similarly situated" if he or she is identical to another individual in every respect except for age; in other words, in circumstances such as period of service, compensation, date of hire, work history, and other respects.[4] "Accrued benefit" is defined by the plan terms; it may be expressed as an annuity payable at normal retirement age, the balance of the participant's cash balance plan account, or some other means. Early retirement subsidies, permitted disparity and certain other plan features are disregarded for this purpose.

In a typical cash balance plan, the employee's benefit accrues evenly over his years of service, with annual service or pay credits to a hypothetical account (usually a fixed percentage of pay, such as 4% to 5%). The amount is determined actuarially to insure that the plan has sufficient funds to provide the promised benefits, and interest is credited at a rate specified in the plan document, and compounded at least annually.

For plan years beginning after 2007, the interest credit (or equivalent amount) for any plan year must be at a rate that is not greater than a market rate of return. A plan will not fail this requirement merely because it provides for a reasonable minimum guaranteed rate of return or for a rate of return equal to the greater of a fixed or variable rate. However, an interest credit of less than zero may not result in the account balance being less than the aggregate amount of contributions credited to the account. Regulations are authorized to define the term "market rate of return."[6] This amendment eliminates the issue of "whipsaw," in which disparate interest rates used for crediting and discounting purposes resulted in the discounted present value of employees' accounts being higher than the actual account value. Earlier regulations state that the interest rate may be a standard interest rate or a variable interest rate (within specified limitations), but that it must be the same for all employees in the plan for all plan years in order to meet certain nondiscrimination safe harbor requirements.[7] Earlier regulations also include special safe harbors for cash balance plans to satisfy various nondiscrimination requirements.[8]

In the case of a conversion of a defined benefit plan to a cash balance plan, the plan's benefit after conversion must not be less than the sum of the participant's accrued benefit for years of service before the conversion under the prior formula, plus the benefit the participant earns under the new formula for service after the conversion.[9] This formula is known by actuaries as an "A+B" approach. This provision is designed to eliminate "wearaway," a time period that occurred in some conversions where older employees might not accrue additional benefits under the cash balance formula until their new hypothetical account balance caught up with their prior accrued benefit.

In plan years beginning after 2007, benefits in cash balance plans must be 100% vested after three years of service (this includes service before the effective date).[10] Requirements for calculation of the present value of a participant's accrued benefit are set forth at IRC Sec. 411(b)(a)(13), as amended by PPA 2006 (effective for distributions made after August 17, 2006).

The Seventh Court of Appeals has held that a cash balance plan formula that was age neutral did not give rise to age discrimination under ERISA, and that an employer's choice to convert from a defined benefit plan (which tends to favor older employees) to a cash balance plan (which does not) is not per se age discrimination.[11] ***ASRS, Sec. 59, ¶265.***

[1] See IRC Sec. 411(b)(1)(H)(i).

[2] IRC Sec. 411(b)(5)(A)(i), as added by PPA 2006.

[3] P.L. 109-280, Sec. 701(e).

[4] See IRC Sec. 411(b)(5)(A)(ii), as added by PPA 2006.

[5] See IRC Sec. 411(b)(5)(A)(iv).

[6] See IRC Sec. 411(b)(5)(B)(i), as added by PPA 2006.

[7] Treas. Reg. §1.401(a)(4)-8(c)(3)(iv).

[8] See Treas. Reg. §1.401(a)(4)-8(c)(3).

[9] See IRC Secs. 411(b)(5)(B)(ii), 411(b)(5)(B)(iii), as added by PPA 2006, effective for conversions occurring after June 29, 2005.

[10] See IRC Sec. 411(a)(13)(B), as added by PPA 2006; P.L. 109-280, Sec. 701(e)(3).

[11] See Cooper v. IBM Personal Pension Plan, ___ F.3d ___, No. 05-3588 (7th Cir. 2006), rev'g 274 F.Supp. 2d (S.D. Ill. 2003).