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## *Cash Balance Plans*

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### *Cash Balance Plans and the Pension Protection Act of 2006 (PPA)*

There has been renewed interest in cash balance plans recently. After years of negative publicity and lawsuits over conversions of traditional defined benefit plans, age discrimination and “whipsaws,” the PPA and some favorable court rulings have rekindled interest in these plans.

### *What is a Cash Balance Plan?*

A cash balance plan can most generally be described as a defined benefit plan that looks like a defined contribution plan. The plan benefits are presented to the participant as a current account balance rather than a monthly annuity benefit commencing at retirement age

The cash balance account is hypothetical. Each year, the account is credited with a contribution, usually a flat dollar amount or a percentage of compensation, as well as an interest credit. The interest credit can be based on a fixed or variable rate, but the basis must be stated in the plan document.

### *Why Choose a Cash Balance Plan?*

- Easily communicated to employees
- Benefits are guaranteed
- Liabilities are predictable
- Greater allocations than defined contribution plans
- Benefits are portable
- Assets protected in bankruptcy

A cash balance plan has the advantage of providing benefits that are easily communicated to participants. Since the plan is a defined benefit plan, the benefits are also guaranteed. The benefits are more meaningful for younger employees and more portable. For older participants, the annual contribution to the hypothetical account can exceed the annual addition limits under IRC Section 415(c) for defined contribution plans. Unlike a traditional defined benefit plan, the value of lump sum benefits are known at any point in time.

The PPA has made significant changes to cash balance plans. It is clear that sponsors of cash balance plans will now have much better estimates of plan liabilities. PPA has also made cash balance plans more attractive for designing plans with secure retirement benefits that are portable and meaningful to participants.

## ***Other Considerations***

- ***Minimum Funding Requirements*** – Cash balance plans are subject to the minimum funding rules for defined benefit plans. Required plan contributions are computed actuarially taking into account actual asset values and usually will not match the total contributions to the hypothetical accounts. The plan will require actuarial certification and a Schedule B.
- ***Investment Risk*** – The employer bears the investment risk and will be required to increase contributions if the investments fall short of expectations. Conversely, contributions will decrease if the investment performance exceeds expectations. Assets are invested on a plan-wide basis and are not self-directed by the participant.
- ***Top-Heavy*** – The IRC Section 416 top-heavy minimum requirements, must be satisfied using the defined benefit rules. The hypothetical account balance must be converted to a life annuity benefit at retirement age and compared with the required life annuity benefit equal to 2% of average compensation for each year of top-heavy service, up to ten years.
- ***Benefit Limits*** – Maximum benefits under IRC Section 415 are determined by converting the account balance to a life annuity and comparing it with the maximum annuity benefit payable. Also, the account balance payable cannot exceed the maximum lump sum payable for traditional defined benefit plans.
- ***Pension Benefit Guaranty Corporation (PBGC)*** – Cash balance plans are subject to PBGC coverage including annual premiums for protected benefits. Generally, plans covering government employees, church employees, only substantial owners or small professional corporations are exempt from PBGC coverage.
- ***Minimum Coverage and Participation Requirements*** – Cash balance plans must satisfy Internal Revenue Code (IRC) Sections 401(a)(26) (*minimum participation i.e. 40% test*) and 410(b) (*minimum coverage i.e. 70% test*).
- ***Non-Discrimination*** – Plans that do not satisfy the safe harbor rules must satisfy the nondiscrimination rules through the general test, using rate groups based on defined benefit accrual rates. These plans may also be “cross-tested” by converting accrual rates to equivalent allocation rates.
- ***Vesting*** – Cash balance plans must fully vest participant accounts after three years of service.
- ***Conversions*** – Traditional defined benefit plans that are converted to cash balance plans where the conversions are adopted or effective after June 29, 2005 can no longer use the wear-away method. The plan must provide accrued benefits that are not less than the accrued benefit under the old plan plus the accrued benefit under the new plan based on years of service after the conversion.
- ***Whipsaw*** – Prior to PPA, a cash balance plan may have had to pay lump sums greater than the hypothetical account balance. This situation, commonly referred to as “whipsaw,” would occur if interest was credited at a rate greater than the rate required to determine minimum lump payouts from defined benefit plans under IRC Section 417(e). PPA allows the plan to define the 417(e) payout to be the hypothetical account balance to avoid a whipsaw problem.