JOURNAL of PENSION BENEFITS

ISSUES IN ADMINISTRATION, DESIGN, FUNDING, AND COMPLIANCE
Volume 29 • Number 3 • Spring 2022

PLAN DISTRIBUTIONS

Post Normal Retirement Age Distributions from Cash Balance Plans: A Primer

BY ALDEN J. BIANCHI

Alden J. Bianchi is the Practice Group Leader of Mintz's Employee Benefits & Executive Compensation Practice. His many published works include the Bloomberg/Bureau of National Affairs Health Care Reform Advisor, a comprehensive work on the impact of the Affordable Care Act on employers and employer-sponsored group health plans. He is also the current chair of the Bloomberg Tax Compensation Planning Journal Advisory Board.

Pity the plight of advisers to cash balance plans. From time to time these intrepid individuals are called on to explain how these plans work, usually to newly enrolled participants. No, there is no real "account;" your account under the plan is merely hypothetical. And, no, you don't get to make your own investment decisions. We hired a professional for that, who will make certain that your annual returns will never even get out of single digits (regardless of whether the stock market is on fire). And, by the way, even though the plan says something is being paid out in the form of an annuity, don't even think about it; anything other than a lump sum will get you in some serious hot water with management. And so it goes.

The problem, of course, is that the cash balance plan design endeavors to fit the proverbial square peg (here a defined benefit pension plan) into the proverbial round hole (here, a defined contribution retirement plan). While these plans have the look and feel of individual account plans, they have all of the baggage of a traditional defined benefit retirement plan. The quirkiness of the cash balance plan design is particularly pronounced in the case of participants who work past their normal retirement age. Just try explaining to an affected participant that his or her benefit accruals be "suspended" or that he or she is effectively and unceremoniously booted out of the plan around age 70.

Background

The rules governing post-normal retirement age benefits accruals and distributions are set out in a series of provisions of the Employee Retirement Income Security Act of 1974 [29 U.S.C. § 1001 et seq.] and the Internal Revenue Code of 1986, as amended (Code). Both these laws recognize two general types of retirement plans: (1) defined benefit plans and (2) defined contribution plans. In general, defined benefit plans provide a specific benefit at retirement for each eligible employee, while defined contribution plans specify the amount of contribution to be made periodically toward an employee's retirement account. In a defined contribution plan, the retirement benefit provided to an employee depends on the aggregate or annual contributions as adjusted for income, gains and losses. A cash balance plan is a defined benefit plan that describes the benefit in terms that are more characteristic of a defined contribution plan.

A cash balance plan expresses the promised benefit in terms of a stated account balance and not as an annuity commencing at normal retirement date in the manner of a traditional defined benefit plan. Code Section 414(i) defines the term "defined contribution plan" as a plan that provides for an individual account for each participant and for "benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses." A defined benefit plan is defined in Code Section 414(j) as "any plan which is not a defined contribution plan." When the employer and not the participant bears the risk of market fluctuations, the benefit is not based "solely on the amount contributed to the participant's account, and any income, expenses, gains and losses." Such a plan is, therefore, a defined benefit plan.

Proponents of cash balance plans claim that the appeal of the cash balance plan design lies in the ease with which the concept can be communicated to participants. In addition, benefits accruals tend to be less back loaded when compared with traditional defined benefit retirement plans—meaning that participants often accrue benefits more evenly over their career, rather than accruing very little when they are young and significant amounts close to retirement. The real appeal of the cash balance plan approach, however lies in the ability to expand the plan's tax leverage following the repeal of the Code Section 415(e), the so-called combined plan limit. Prior to 2000, Code Section 415(e) provided an overall limitation on the total amount of benefits and contributions that can be received or accrued by an employee who is a participant in both a defined benefit plan (or plans) and a defined contribution plan (or plans) sponsored by the same employer. Section 1452(a) of Small Business Jobs Protection Act of 1996 [Pub. L. 104-188, 110 Stat. 1755] repealed Section 415(e) of the Code, effective for limitation years beginning after December 31, 1999. Here are the uncoupled limits:

- *Code Section 415(b): Defined benefit plan limits.* Under Code Section 415(b), an individual's pension benefit amount is capped at the lesser of a specified dollar amount indexed each year ($245,000 for 2022) or the individual's highest three-year average compensation. Compensation for this latter purpose is limited to the amount specified in Code Section 401(a)(17) ($305,000 for 2022), and the benefit for this purpose means the amount payable annually as a straight life annuity beginning at normal retirement.
- *Code Section 415(c): Defined contribution plan limits.* Under Code Section 415(c) total "annual additions" to a participant's defined contribution plan account(s) may not exceed a specified dollar limit ($61,000 for 2022) or 100 percent of a participant's compensation. The limit applies to the total of 401(k) elective deferrals (but not catch-up contributions), after-tax employee contributions, employer matching and non-elective contributions, and allocations of forfeitures [Code §§ 401(a)(16), 415(c); Treas. Reg. § 1.415(c)-1].

Under current law, an individual who participates in both a 401(k) plan and a cash balance plan gets the benefit of both limits without any diminution or offset. This makes cash balance plans attractive to businesses with large cohorts of highly compensated employees for whom a 401(k) plan alone is insufficient to provide meaningful retirement benefits.

While not required, cash balance plans often include multiple contribution tiers. In a typical business this would mean higher contributions for the business owners and managers with smaller contributions for staff. In a professional services firm, the contributions might be based on the classes of subcategories of owners. Cash balance plans with these sorts or design features usually are adopted alongside of, and tested in conjunction with, other defined contribution plans in order to facilitate compliance with applicable coverage, minimum participation and other non-discrimination testing rules. [*See* Code § 401(a)(4), § 410(b) (nondiscrimination and minimum

participation), § 401(a)(26) (minimum participation), § 415 (maximum benefits), § 411(b) (accrued benefit requirements), § 416 (top heavy minimums), and § 436 (restrictions on payments of lump sums)]

In a cash balance plan, a participant's account is credited each year with a "pay credit" (for example, a percentage of compensation or a fixed dollar amount) and an "interest credit." Owning to the challenges presented by anti-cutback rules under Code Section 411(d)(6) and the rules that bar back-loading of accruals under Code Section 411(b), it was not always clear whether a variable interest crediting rate could pass muster in the context of a cash balance plan. Code Section 411(d)(6) generally prohibits a plan amendment that decreases a participant's accrued benefits with respect to benefits attributable to service before the amendment. The right to future interest credits is a part of a participant's accrued benefit [*See generally* Code § 411]. Thus, a reduction in the rate of return owing to year-over-year decline in the investment return looked suspiciously like a cutback in a participant's accrued benefit. The Pension Protection Act of 2006 (PPA) [Pub. L. 109-280, 120 Stat. 1040] addressed these concerns and paved the way for an alternative under which interest is credited based on market rates of return. (These rules are discussed below.) Final regulations issued in 2014 [Treas. Reg. § 1.411(b)(5)-1] (also discussed below) establish a rule under which a cash balance plan may use market-based interest credits based on the actual rate of return on actual investments if the plan's assets are diversified, subject to certain limits that have the effect of imposing a collar in crediting rates.

Under the cash balance plan "preservation of principal" rule, a participant's benefit determined as of the participant's annuity starting date may be no less than the benefit based on the sum of all principal credits credited under the plan to the participant as of that date. [Treas. Reg. § 1.411(b)(5)-1(d)(2)(i)] As a consequence, annual returns can be either positive or negative, but the cumulative return cannot be negative.

Cash balance plans often rely on cross testing to satisfy the applicable non-discrimination rules [Treas. Reg. § 1.401(a)(4)-8(b)]. Cross-testing generally requires annual increases in a participant's account be projected forward to a testing age (typically age 65) at a standard interest rate [Treas. Reg. § 1.401(a)(4)-12], which is between 7.5 percent and 8.5 percent. The standard interest rate indirectly operates to cap market value cash balance plan returns. While there is no clear authority, the consensus view is that, where a cash balance plan's rate of return fluctuates, it is the prior year's returns that are applied for this purpose. [*See* Treas. Reg. §1.430(d)-1(f)(3) (directing "actuaries to use their best estimate of anticipated experience under the plan based on information determined as of the valuation date. . ."). The common practice is to project the current interest rate forward to normal retirement date] Usually, high rates of return would tend to return discriminatory values. For this reason, it is not uncommon to encounter caps on investment returns in market value cash balance plans. Investment returns in excess of the plan's cap are applied to reduce future contributions.

The Cash Balance Plan Accrued Benefit

The Accrued Benefit under a Defined Benefit Plan

Code Section 401(a) generally required that a defined benefit plan be established and maintained primarily to provide systematically for the payment of definitely determinable benefits after retirement or the attainment of normal retirement age [Treas. Reg. § 1.401(a)-1(b)(1)(i)]. ERISA Section 3(23) and Code Section 411(a)(7) each define the term "accrued benefit" to mean an annual benefit commencing at normal retirement age" [*Accord* Treas. Reg. § 1.411(a)-7(a)(1)(i)]. In the case of a defined contribution plan, an individual's accrued benefit is his or her current account balance. [Code § 411(a)(7), § 411(b); ERISA § 204, § 3(23); Treas. Reg. § 1.411(b)-1. Benefit accrual also refers to the *rate* at which benefits are earned by participants. Benefit accrual is different from vesting, which refers to the time when benefits are no longer forfeitable to the participant.] In the case of a defined benefit plan, including a cash balance plan, the accrued benefit usually is expressed as an annual benefit beginning at normal retirement age [Code § 411(a)(7)]. If a benefit is paid at *any* other time or in *any* other form, it must be adjusted to be the actuarial equivalent of the normal form of benefit.

This definition of what constitutes an accrued benefit is so familiar to seasoned benefit practitioners that it is sometimes easy to miss its simplicity and mathematical precision. Mathematically, an individual's accrued benefit at normal retirement age can be expressed as the area under a curve f(t) on the interval [a,b], where a denotes the individual's commencement of participation in the plan and b denotes the individual's normal retirement date. Thankfully, because accruals take place at discreet points in time that

correspond to positive, whole integers (for example, monthly or annually) actuaries and others who administer cash balance plans need not resort to the calculus to arrive at that value of an accrued benefit—basic algebra will suffice. It is also possible to lose sight of its importance. The balance of the hypothetical account is the actuarial equivalent of the normal form of benefit, which is an annuity. In the case a married participant, the normal form of benefit is a 50 percent joint and survivor annuity; in the case of an unmarried participant, a straight life annuity [Code § 401(a)(11), § 417(b); ERISA § 205; Treas. Reg. § 1.401(a)-11, § 1.401(a)-20, § 1.417(e)-1].

The Cash Balance Plan Safe Harbor

Before the enactment of the PPA, both the Treasury Department and most courts took the position that a participant's cash balance includes not just the current pay credits but also interest projected to normal retirement age and then converted to an annuity commencing at the participant's normal retirement date at the plan's interest crediting rate. [IRS Notice 96-8, 1996-1 C.B. 359] The amount of the lump-sum distribution must be converted back to a lump sum and discounted to the participant's current age using the interest rate and mortality table specified in Code Section 417. The problem, of course is that, if, as is often the case, the plan's interest rate is higher than interest rate specified by Code Section 417, then the current lump sum could be much higher than the current value of the notional cash balance benefit. This result is referred to as "whipsaw" or "the whipsaw effect."

PPA Section 701(b)(2), adding Code Section 411(b)(1)(H)(i), eliminated the whipsaw 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. [Code § 411(a)(13)(A)] Final regulations, which become effective as of January 1, 2017, established a series of safe harbor rates and other rules, which, if satisfied, resulted in a cash balance plan being deemed to satisfy the anti-cutback rules. While cash balance plans are not required to qualify for the safe harbor, most plan sponsors choose to operate their plans in accordance with these rules.

Benefit Suspensions Post Normal Retirement Age

Each of ERISA Section 3(23) and Code Section 411(a)(7) refer to an *annual benefit commencing at normal retirement age*. But what happens when a participant continues to work past normal retirement age? It is here that the differences between defined contribution and defined benefit plans come into stark relief. In a defined contribution plan, the short answer is—nothing. The participant's accrued benefit is the account balance, as adjusted for interest gains and losses. In a defined benefit plan, the short answer is—something, a lot actually. In a defined benefit plan, a participant has a legally binding right to an annuity commencing at normal retirement age, which in the case of a cash balance plan the participant may, is routinely encouraged to, and usually does, elect to have paid in the form of a lump sum. Where the benefit is paid or commences to be paid after normal retirement age, additional rules apply. (While this approach does not appear to be all that common, a plan could simply provide for the commencement of retirement benefits at normal retirement age despite the participant continuing to work in which case no adjustment is necessary.)

The rules governing benefit post-normal retirement age distributions consist of a general rule and an exception. [*See generally*, Treas. Reg. § 1.411(b)(5)-1] Under the general rule, a defined benefit plan must provide an employee who continues working after normal retirement age with an actuarial increase in the benefit payable at normal retirement age; under the exception the plan can suspend benefits for a time. A "suspension' for this purpose means the permanent withholding (that is, forfeiture) of a participant's benefit payment for each month in which the participant is in disqualifying employment [29 CFR § 2530.203-3] after reaching their normal retirement age. Disqualifying employment generally requires that the participant be employed full-time by the employer maintaining the plan under which the benefits are being paid.

While these rules were intended to address instances in which a retiree receiving benefits under the plan becomes reemployed, they do not require actual retirement. The rules apply equally to participants who remain actively employed, continuing to work after reaching their normal retirement age. When a participant's benefit is appropriately suspended, no adjustment to a participant's accrued benefit is required.

Treas. Reg. § 1.411(b)(5)-1(b)(1)(ii) clarifies that cash balance plans (and hybrid plans generally) are subject to the general requirements for post-normal retirement age adjustments and permitted suspension

of benefits under Code Section 411(a). This means that a participant's post-normal retirement age account balance must be sufficiently increased to satisfy the actuarial increase requirements or benefits must be duly suspended. [Treas. Reg. § 1.411(a)(13)-1(b)((2)] Most cash balance plans suspend benefits. As a consequence, the plan need not provide both an additional accrued benefit earned after normal retirement age and the actuarial equivalent of the accrued benefit at normal retirement age. [*See generally* Treas. Reg. 1.411(b)(5)-1]

While these rules can be complicated to apply in the case of traditional single employer and multi-employer defined benefit plans, applying them to cash balance plans usually presents little difficulty. However, strict notice requirements do apply. To suspend a participant's benefit, the plan must furnish the participant with a written suspension of benefits notice. 29 CFR § 2530.203-3(b)(4) sets out rules governing the content and timing of the notice.

The suspension of benefit rules are an exception to the Code's and ERISA's vesting rules under which participant's right to his or her accrued benefit must be non-forfeitable at normal retirement age. [*See e.g.*, Code § 411(a)] If a plan does not contain provisions providing for the suspension of benefits, the anti-cutback rules [Code § 411(d)(6)] prohibit the Plan from adding the suspension provision to benefits accrued prior to the adoption of the new provisions.

Where the suspension of benefits rules are properly invoked and followed, the plan can continue to provide pay credits and market-rate earnings adjustments. The result is that the plan continues to have the appearance of an account-based plan. The suspension of benefit rules can create the illusion of normalcy for only so long, however. There comes a point where the rules governing required minimum distributions intrude.

Required Minimum (and Other) Distributions

Tax-favored retirement benefits have long been subject to rules requiring distributions, thereby ensuring that the tax could not be delayed indefinitely. Code Section 401(a)(9) was added to the Code by the Self-Employed Individuals Retirement Act of 1962v [Pub. L. 87-792] and was expanded to all qualified plans by Section 242 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). TEFRA required the distribution of the entire interest of the employee, in the taxable year the participant attains age 70½ or, in the case of a non-key employee, retires, if later. Alternatively, TEFRA permitted the amount to be distributed over the remaining life expectancy of the participant and his/her spouse. This requirement has thereafter been changed from time-to-time by statute and further elucidated by regulations.

The Tax Reform Act of 1986 (TRA '86) [Pub. L. 99-514] revised the date on which distributions must commence (a participant's "required beginning date") to mean April 1 of the year after the year in which a participant turns age 70 ½ despite that the participant is still working. The Small Business Job Protection Act (SBJPA) of 1996 [Pub. L. 104-188, 110 Stat. 1755] further amended the definition of required beginning date to mean April 1 after the year of retirement for participants (other than 5 percent owners) who work past age 70½. Most recently, the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 increased the age for the commencement date from age 70-1/2 to 72. [*But see* Section 2203 of the CARES Act (suspending required minimum distributions for defined contribution plans, but not defined benefit plans for the 2020 tax year)] (The balance of this article assume that participants are not 5 percent owners.)

The Pension Protection Act of 2006 (PPA 2006) [Pub. L. 109-280, 120 Stat. 1040] allows defined benefit pension plans to provide for in-service distributions to a participant who has reached age 62, even if the plan's normal retirement age is later than age 62. Code Section 401(a)(36) The Bipartisan American Miners Act of 2019 (Division M of Pub. L. No. 116-94) reduced the minimum age for in-service distributions from age 62 to age 59½ (again, irrespective of the plan's normal retirement age), and the SECURE Act changed the rules governing required minimum distributions that are not mandatory [Treas. Reg. § 1.401(a)(9)-6]. Where a plan does not adopt the new rule, payments made before the required beginning date are not required distributions under Code Section 401(a)(9). They are therefore eligible for rollover in their entirety provided that they otherwise qualify as eligible rollover distributions.

Where a participant's benefit is suspended prior to his required beginning date (April 1 following the year the participant attains age 72 or 70 ½ depending on the participant's date of birth), the participant's benefit must be actuarially adjusted if the participant continues working. [Treas. Reg. § 401(a)(9)-6. Q&A 8 (noting that "unlike the actuarial increase required under Section 411, the actuarial increase required under Section 401(a)(9)(C)(iii) must be provided even during any period during which an employee's benefit

has been suspended in accordance with ERISA Section 203(a)(3)(B)")] There is, however, an important nuance for cash balance plans that suspend benefits because of what the SECURE Act did not change: Both before and after the act, Code Section 401(a)(9)(C)(iii) read and reads as follows:

> **Actuarial Adjustment—**
>
> In the case of an employee [] who retires in a calendar year after the calendar year in which the employee attains age 70 1/2, the employee's accrued benefit shall be actuarially increased to take into account the period after age *70 1/2* in which the employee was not receiving any benefits under the plan. (Emphasis added).

Under this provision, benefits that were previously suspended under the above-described suspension of benefits rules must again be adjusted where payment is further delayed. For this reason, cash balance plans that suspend benefits often require that benefits commence at age 70 ½. A participant who continues to work past this age may still accrue benefits, but they are distributed out of the plan in the same year in which they are accrued. Participants generally welcome these distributions since they may be rolled over into an Individual Retirement Account or another qualified plan.

The Preference for Lump Sum Distributions

Because a cash balance plan is a defined benefit plan, the default form of distribution is annuity. This, despite that the benefit is expressed as an account balance. Provided that plan satisfies the safe harbor rules prescribed by the 2014 final rules, the cash balance plan lump sum is the participant's hypothetical account balance. The equivalent annuity is derived by dividing the hypothetical account balance by the actuarial equivalence factors specified in the plan document. This is in contrast to traditional defined benefit plans in which the annuity is determined first, then the lump sum is determined as the present value of that annuity.

While the lump sum and annuity benefits under any defined benefit are required as a matter of law to be equivalent, this is generally not the case in practice. Annuity benefits are typically paid through the purchase of a commercial annuity (particularly at termination of the plan), which often are priced conservatively and include sales loads. Commercial annuity issuers also worry that less healthy participants will gravitate toward the lump sum option, leaving the healthier participants with longer life expectancies in the annuity contract. Lumps sums are, therefore, less expensive. For this reason, plan sponsors generally encourage participants to choose a lump sum distribution.

Cash Balance Plan "Strategic" Terminations

Perhaps the oddest practical feature of cash balance plan operation is it what is euphuistically referred to as "strategic" plan termination. The reference is to a plan termination of a "mature" cash balance plan, that is, a plan that has been in place for a number of years, followed by distribution of assets and subsequent adoption of a new cash balance plan. Strategic plan terminations are often driven by the desire to escape the limited cash balance plan investment constraints by transferring assets to a 401(k) plan or individual retirement account (IRA). The attraction, of course, is that in the latter vehicles participants and account holders may choose their investments.

Whether and under what circumstances a plan sponsor can engage in a strategic plan termination absent a business necessity (for example, sale of a business or bankruptcy) is a topic that is governed as much by urban legend as by any reliable regulatory guidance. Claims of what constitutes a mature plan that can be terminated range from a plan that has been in existence for at least three years to at least ten years, and there is little consensus on whether the design of the successor plan must be different, or whether it can be identical to the terminating plan.

Under Treas. Reg. § 1.401-1(b)(2), for a plan to qualify for the tax benefits accorded by Code Section 401(a), the plan must be a permanent, rather than a temporary, program. The rule is referred to as the plan permanency requirement. According to the Internal Revenue Service (IRS) Internal Revenue Manual [Section 7.12.1.3 (02-16-2017)]:

> If a plan terminates within a few years after its initial adoption, the plan sponsor must give a valid business reason for the termination or there's a presumption that the plan was not intended to be a permanent program from its inception. However, the qualification of a long-established plan that terminates without a valid business reason is not adversely affected.

The termination of a plan for any reason other than business necessity within a few years after it has taken effect is treated as evidence that the plan from its inception was not a bona fide permanent program

for the exclusive benefit of employees. Permanency for this purpose is determined based on the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. The regulation does not tell us what constitutes "a few years." But according to Rev. Rul. 72-239, a plan that has been in existence for over 10 years can be terminated without a business necessity. Rev. Rul. 69-25 adopts a presumption that a plan terminated within a few years of its inception where the sponsor is otherwise able to continue the plan fails that permanency requirement. The plan sponsor can rebut this presumption by demonstrating that the termination was due to business necessity that could not reasonably have been foreseen when the plan was adopted.

Terminating a plan merely for the purpose of freeing up assets so that participants can gain access to a broader range of investment options would not qualify as a valid business reason. So, for a strategic termination to pass muster under the plan permanency rule, the plan sponsor must rely on the "few years" prong of Treas. Reg. § 1.401-1(b)(2). The consensus appears to be that terminating a plan that had only been in existence for three to five years followed by a new plan would not satisfy the permanency requirement. There is the separate question of whether the new plan design may be identical to the old plan? Or must there be differences? If the plan design does not change or if the change is marginal, one supposes that the IRS could on audit or examination assert that plan is effectively continuing with perhaps some minor amendments. Despite these concerns, strategic plan terminations followed by the adoption of an identical or substantially similar plan appear to be commonplace.

Conclusion

Despite their complexities, drawbacks and challenges, cash balance plans are gaining in popularity. According to a recent report [*https://assets.futureplan.com/futureplan-assets/National-Cash-Balance-Research-Reports-2020-FuturePlan.pdf*], the number of new Cash Balance plans increased 17 percent from 2017 to 2018, compared with just 2 percent growth in new 401(k) plans. This should surprise no one, for many of the reasons cited above. Cash balance plans can greatly increase tax leverage, and they make intuitive sense to participants. Under the hood, however, the story is quite different.

Not only are cash balance plans burdened by all of the complexity of any defined benefit pension plan, the design features that make them easy for participants to grasp add additional hoops through which plan sponsors and their advisors must jump. Nowhere is this more apparent than in the case of post normal retirement age distributions. As a result, participant communication is essential. For this reason, plan sponsors often supplement the summary plan description with plan Q&As and other communications as well as participant meetings, videos and other materials. There is a good deal that can go wrong, and it takes a corresponding good deal of effort to get it right. ■

Copyright © 2022 CCH Incorporated. All Rights Reserved.
Reprinted from *Journal of Pension Benefits*, Spring 2022, Volume 29, Number 3, pages 22–28, with permission from Wolters Kluwer, New York, NY, 1-800-638-8437, www.WoltersKluwerLR.com

Wolters Kluwer