DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF THE CHIEF COUNSEL

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The Honorable Patrick Meehan
Member, U.S. House of Representatives
940 West Sproul Road
Springfield, PA 19064

Attention:

Dear Representative Meehan:

I am responding to your inquiry dated August 3, 2017, on behalf of your constituent, . He needs our help understanding the rules of his retirement plan and asked:

- How do the rules that apply to a defined benefit retirement plan affect my situation?
- How do the rules affect how an employer pays the benefit under a cash balance plan?

In general, there are two types of qualified retirement plans:

- A defined benefit retirement (DB) plan (for example, a traditional pension plan)
- A defined contribution retirement (DC) plan (for example, a 401(k) plan)

Explanation of cash balance plans

A cash balance plan is a type of DB plan. A traditional DB plan defines a participant's retirement benefit as an annuity starting at normal retirement age. A cash balance plan, however, defines a participant's benefit as an account balance (similar to a participant's account balance under a DC plan). Unlike a DC plan, the account balance under a cash balance plan is hypothetical rather than an actual separate account in the participant's name. Because there is not an actual account with funds in it, the benefit paid to the participant may be different from the account balance.

Explanation of benefits under cash balance plans

Typically, a participant in a cash balance plan accrues pay credits while working (similar to contributions under a DC plan). A participant also accrues interest credits until the plan pays benefits to the participant (similar to interest or earnings in a DC plan) that is meant to adjust the benefit to account for the time value of money. In general, the rules under the Internal Revenue Code (Code) that apply to all DB plans (such as traditional DB plans), also apply to cash balance plans. The rules that apply only to DC plans (such as 401(k) plans) do not apply to cash balance plans.

Explanation of how the Code limits the benefit under DB plans

Section 415(b) of the Code puts a dollar limit on the amount of the benefit a DB plan participant may receive as a distribution. A DB plan cannot distribute a benefit in excess of the limit, regardless of the form of benefit (for example, a lump sum distribution or annual annuity benefit). The maximum benefit under the law is the lesser of two amounts, each expressed as an annual annuity benefit:

- The statutory dollar limit (which is adjusted every year and is $215,000 for 2017)
- The participant's average highest three years of compensation

This maximum benefit is referred to as the Section 415(b) limit. Applying this limit may require certain adjustments based on the age the participant begins receiving the benefit. Applying this limit may also require calculations to change the form of the benefit payments to a form comparable to the limit, for example:

- If a DB plan pays an annuity benefit earlier than age 62, the plan reduces the amount of the Section 415(b) limit based on assumptions about the participant's life expectancy and how interest rates will change.
- If the plan pays the benefit in a form other than an annuity, such as a lump sum, the plan converts the benefit to an annual annuity benefit in order to compare it to the Section 415(b) limit that is expressed as annual annuity benefit. The Code prescribes the interest rate and life expectancy assumptions that the plan must use to convert the form of benefit to an annuity benefit.

A cash balance plan that pays a lump sum benefit may not pay a lump sum that is greater than the dollar amount determined under Section 415(b). The amount of the benefit that exceeds the Section 415(b) limit is determined by converting the nominal lump sum amount to an equivalent annuity and comparing that annuity to the Section 415(b) limit that applies at the participant's age. The employer may pay any amount in excess of the Section 415(b) limit through another arrangement that is not a qualified retirement plan. However, the Code does not require employers to pay amounts over the Section 415(b) limit to the employee.

I hope this information is helpful. If you need further assistance, please contact me at or at .

Sincerely,

for Victoria Judson
Associate Chief Counsel
(Tax Exempt and Government Entities)