

Restrictions on Benefit Payments to Certain Highly Compensated Employees under Defined Benefit Plans, Including Cash Balance Plans

All qualified defined benefit plans (including cash balance plans) must contain a provision that restricts the amount of benefits that can be paid in certain instances. These restrictions are described in Treas. Reg. 1.401(a)(4)-5(b). These restrictions do not apply to defined contribution plans such as 401(k) and profit sharing plans. The purpose of the restrictions is to prevent certain highly compensated participants from taking large lump sum distributions and leaving the plan under funded with respect to the other participants.

General Rule.

A defined benefit plan must provide that the payment of benefits to or on behalf of a **restricted employee** cannot exceed an amount equal to the payments that would be made in that year under –

- √ A straight life annuity that is the actuarial equivalent of the accrued benefit and other benefits to which the restricted employee is entitled under the plan (other than a Social Security supplement); and
- √ A Social Security supplement, if any, that the restricted employee is entitled to receive.

Plans often want to pay lump sum distributions which exceed the amount described above. It is necessary to determine whether or not the payment of certain lump sums is permissible.

Who is a Restricted Employee?

The term restricted employee generally means any HCE or former HCE who is among the 25 nonexcludable employees and former employees of the employer with the largest amount of compensation in the current or any prior year.

Exceptions Provided by Treasury Regulation

The General Rule does not apply if any of the following conditions are satisfied:

- √ After taking into account payments to or on behalf of the restricted employee, the ratio of the plan's assets to the value of its current liabilities equals or exceeds 110%.

Current liabilities must be calculated based on interest assumptions specified by law. These interest rates change each year and the current liability can rise or fall as the interest rates change. Current liabilities also rise as participants accrue additional benefits, usually upon completion of 1,000 hours of service during a plan year.

Plan sponsors may want to make benefit payments prior to the time participants accrue these additional benefits, that is, prior to a known decline in the asset to current liability ratio.

- ✓ The value of the benefits payable to or on behalf of the restricted employee is less than one percent of the value of the plan's current liabilities prior to the distribution.
- ✓ The value of the benefits payable to or on behalf of the restricted employee does not exceed \$5,000.

Other Exceptions

Revenue Ruling 92-76 provides that a plan will not violate the restrictions described in the General Rule provided the plan includes adequate provisions to secure any necessary repayment in the event of a plan termination. The following are considered to be adequate provisions to secure the necessary repayment:

- ✓ The plan provides that, upon receipt of a distribution from the plan, the restricted employee deposits in escrow property having a fair market value equal to at least 125 percent of the restricted amount
- ✓ The plan provides that, upon receipt of a distribution from the plan, the restricted employee posts a bond or letter of credit in an amount equal to at least 100 percent of the restricted amount.

Final Note

Determining whether or not a benefit must be restricted can be complicated. Your Kravitz consultant can assist you in making this determination.

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