PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

February 2, 2004
JS-1132

Preserving Cash Balance Plans for Workers: Treasury Proposes Legislation to Protect Defined Benefit Plans and Ensure Fair Treatment of Older Workers in Cash Balance Conversions

Today, the Treasury Department proposed legislation to ensure the fair treatment of older workers in cash balance conversions.

"This proposal will make sure that every company converting to a cash balance plan deals fairly with its older workers," said Secretary John Snow. "Cash balance plans play an important role in achieving retirement security for millions of American workers and their families. But we must make sure that companies changing from a traditional pension to a cash balance pension include a fair transition for older workers. Cash balance plans can be a better option, particularly for today's younger, more mobile workforce."

A cash balance plan is a pension plan that combines the benefit formula of a defined contribution plan with the worker investment security of a defined benefit plan. Cash balance plans are better suited to a mobile workforce because employees accrue more substantial benefits earlier in their careers and can take their cash balance benefits with them as they move from job to job. Under a cash balance plan, a hypothetical account is set up for each worker and is credited with hypothetical pay and interest credits. Most cash balance plans have been set up by "converting" traditional defined benefit plans.

Treasury's proposal would ensure fairness for older workers in cash balance conversions. The proposal would impose a 5-year "hold harmless" period after each conversion. During this period, the benefits earned by any worker under the cash balance plan would have to be at least as valuable as the benefits the worker would have earned under the traditional plan if the conversion had not occurred. The proposal would ban any "wear-away" of retirement benefits, so that all workers would earn benefits immediately after the conversion.

These protections would be enforced through a 100 percent excise tax. The tax would not apply if a company gives workers a choice between the traditional plan and the cash balance plan or if the cash balance conversion grandfathers current workers.

The proposal would also clarify that cash balance plans do not violate the age-discrimination rules that apply to pension plans as long as they treat older workers at least as well as younger workers. This would remove uncertainty created by inconsistent federal court decisions and would ensure the future of cash balance plans.

The proposal would also eliminate the “whipsaw” effect, which acts as a cap on the interest credits that cash balance plans can provide to workers. This would permit companies to give higher interest credits, allowing larger retirement accumulations for workers.

All changes would be effective prospectively from enactment of the proposal.

Attachments:
Cash Balance Plan FAQ
Cash Balance Plan Proposal

Frequently Asked Questions on Treasury’s Proposal for Cash Balance Plans

What are the goals of the proposed legislation for cash balance plans?

The proposal would accomplish three major objectives. Specifically, the proposal would:

- Protect the defined benefit system by clarifying the status of cash balance plans.
- Ensure fairness for older workers in cash balance conversions.
- Remove the cap on interest credits in cash balance plans.

Together, these objectives will help strengthen the defined benefit system while ensuring that companies treat older and longer-service workers fairly when they convert to cash balance plans.

What is a cash balance plan?

A cash balance plan is a type of tax-qualified retirement plan. It is often described as a “hybrid” plan because it combines features of a defined benefit plan and a defined contribution plan.

A cash balance plan provides for annual “pay credits” to an employee’s “hypothetical account” and “interest credits” on the balance in the hypothetical account. For example, a cash balance plan might provide for pay credits each year equal to 5 percent of compensation, with interest at the rate on long-term Treasury bonds.

The plan is a defined benefit plan, so the employer bears all investment risk and benefits are insured through the Pension Benefit Guaranty Corporation. Otherwise, the plan functions much like a defined contribution plan from the perspective of an employee.

The Pension Benefit Guaranty Corporation estimates that there are more than 7 million American workers covered by cash balance and other hybrid plans.

How does a cash balance plan differ from a traditional defined benefit plan?

A cash balance plan states the employee's benefit as an account balance, much like a 401(k) plan. A traditional defined benefit plan typically states the employee's benefit as an annuity payable at normal retirement age. The annuity is often expressed as a combination of a percentage of final average pay and years of service (for example, an annual annuity equal to 1 percent of final average pay times years of service).

A traditional plan delivers most of its value to an employee in the very last years before retirement. By contrast, a cash balance plan provides for more level accruals throughout an employee's working career.

Recent studies have shown that cash balance plans help employers compete in tight labor markets because of the more level accruals of cash balance plans. This is especially true where employers are trying to attract and retain more "mobile" workers. Studies have also suggested that cash balance plans may provide higher benefits for a majority of the next generation of workers than would traditional defined benefit plans.

So cash balance plans have an important role to play in the retirement security of millions of American workers and their families.

What is a cash balance conversion?

When an employer amends a traditional defined benefit plan to become a cash balance plan, that process is known as a conversion. Most cash balance plans have been set up in this way.

Why is this legislative proposal needed?

Cash balance conversions can result in unfair treatment of older and longer-service workers because of the abrupt change from the traditional formula to a cash balance formula.

Many employers have voluntarily provided transition relief for older and longer-service workers. But ensuring the fair treatment of older and longer-service workers in conversions requires strengthening current law.

Current law does not protect the future expectations of older and longer-service employees affected by cash balance conversions, and it does not give Treasury the authority to impose fairness requirements for conversions. This very important issue has to be resolved through a change in the law.

What does the legislative proposal say about cash balance conversions?

The proposal requires that an employer converting to a cash balance plan provide for fair treatment of its older and longer-service workers. The proposal would do this in two ways.

First, the proposal would impose a 5-year “hold harmless” period after each conversion. During this period, the benefits earned by any employee under the cash balance plan would have to be at least as valuable as the benefits the employee would have earned under the traditional plan if there had been no conversion.

Second, the proposal would ban any wear-away of benefits at any time after the conversion. A wear-away occurs when an employee’s benefits under the cash balance plan have to “catch up” with the benefits already accrued under the traditional plan. This means that some employees do not earn new benefits for a period after the conversion. By banning wear-away, the proposal would make sure that all employees immediately earn new benefits after the conversion.

Why is the “hold harmless” period 5 years?

The hold harmless period has to protect reasonable expectations of older and longer-service employees. At the same time, it cannot be so burdensome that the company decides to freeze the plan entirely, which harms all employees. A 5-year period strikes this balance.

Along with the complete ban on benefit wear-away, the 5-year period will ensure a fair transition for older and longer-service employees to the cash balance formula. In particular, employees who are within 5 years of normal or early retirement will have full protection under this proposal.

How would the new conversion rules be enforced?

The new conversion rules would be backed up by a 100 percent excise tax on the employer. The tax would apply to any shortfall between the benefits required under the new rules and the benefits actually provided by the cash balance plan. We believe that, faced with such an excise tax, employers will provide the benefits required under the proposal.

Some employers may convert to cash balance plans because they are experiencing adverse business conditions. For this reason, the amount of the excise tax would not exceed the greater of the plan's surplus assets at the time of the conversion or the plan sponsor's taxable income.

Would the excise tax apply if the employer provided some other kind of protection for its older and longer-service workers?

The excise tax would not apply if employees were given a choice between the traditional plan and the cash balance plan or if the conversion grandfathers current employees under the traditional plan. This would preserve flexibility of plan sponsors to implement other protections for older and longer-service employees.

Does this mean that Treasury thinks cash balance conversions violate the age-discrimination rules?

The legislative proposal released today goes beyond current law to ensure that every cash balance conversion provides for fair treatment of older and longer-service employees. In December 2002, Treasury and the IRS proposed regulations that interpret the current age-discrimination rules in the context of cash balance plans and cash balance conversions. Those regulations say that some, but not all, cash balance conversions could be age-discriminatory.

These new rules would apply even if the conversion satisfies the current age-discrimination rules.

Don't employers convert to cash balance plans mainly to save money on their pension obligations?

The evidence on the motivation for cash balance conversions is mixed. One recent study states that a majority of large companies had higher costs after a conversion while another suggests that costs were slightly reduced on average. Regardless, cost savings is only one of many possible motives for conversion. Even where an employer converts to save money, the conversion is preferable to simply freezing or terminating the plan, as long as older and longer-service workers are treated fairly.

What does the legislative proposal say about cash balance plans?

The proposal would clarify the legal status of cash balance plans under current law.

The federal courts have split on the question whether cash balance plans satisfy the age-discrimination rules. This has created uncertainty about the basic legality of these plans. Removing that uncertainty is critical to preserving the vitality of the defined benefit system, which provides retirement income security for millions of American workers and their families.

The proposal would clarify that a cash balance plan satisfies the age-discrimination rules if the plan provides pay credits for older and longer-service employees that are not less than the pay credits for younger employees and if the interest credits are not discriminatory.

The proposal would also clarify that certain transition strategies used in conversions do not violate the age-discrimination or other applicable rules. This would allow companies that convert to preserve the value of early retirement subsidies, for the benefit of employees, without violating the law.

The proposal would provide similar rules for other types of hybrid plans, such as pension equity plans.

Hasn't a federal court already said that cash balance plans are illegal?

One federal district court in Illinois said that one company's cash balance plan violates the age-discrimination rules (Cooper v. IBM Personal Pension Plan). However, other federal district courts have reached the opposite conclusion on other cash balance plans (Eaton v. Onan Corp.; Campbell v. BankBoston). These inconsistent decisions have left the law in a state of uncertainty.

So does this mean that Treasury thinks cash balance plans are good plans?

Treasury believes that cash balance plans have an important role to play in providing retirement security for millions of American workers and their families. However, Treasury also believes that the transition from a traditional defined benefit plan to a cash balance plan must provide for the fair treatment of older and longer-service workers. That is why the proposal calls for new transition protections in cash balance conversions.

What does the legislative proposal say about "whipsaw"?

The proposal would eliminate whipsaw on a prospective basis.

This means that a cash balance plan could distribute an employee's account balance as a single sum as long as the plan does not credit interest at an above-market level. This would permit plan sponsors to give higher interest credits to employees, allowing larger retirement accumulations.

What exactly is whipsaw?

Whipsaw is an interpretation of current law, set out in IRS Notice 96-8, that says that cash balance plans must increase single sum distributions above employee account balances for future interest credits. This interpretation was never set out in formal IRS regulations. Nevertheless, three federal courts of appeals have followed the Notice 96-8 interpretation.

Whipsaw applies if the plan provides an interest crediting rate above the rate on 30-year Treasury bonds (or an equivalent rate).

So does that mean that the proposal will reduce employee distributions?

Absolutely not. The proposal would be effective on a prospective basis, so no employee would get a dollar less than what they would get without this new legislation.

In the future, the distributions of many employees should increase because the proposal will allow their employers to provide more generous interest credits, resulting in higher account balances and higher distributions.

What is the effective date of the proposal?

The entire proposal would be effective for periods after enactment. That means that the new rules will not apply before the date Congress enacts this proposal.

ENSURE FAIR TREATMENT OF OLDER WORKERS IN CASH BALANCE CONVERSIONS AND PROTECT DEFINED BENEFIT PLANS

Current Law

Qualified retirement plans consist of defined benefit plans, which allocate investment risk to the plan sponsor, and defined contribution plans, which allocate investment risk to plan participants. In recent years, many plan sponsors have adopted cash balance and other "hybrid" plans that combine features of defined benefit and defined contribution plans. A cash balance plan is a defined benefit plan that provides for annual "pay credits" to a participant's "hypothetical account" and "interest credits" on the balance in the hypothetical account. As with traditional defined benefit plans, the sponsor of a cash balance plan bears investment risk (as well as some mortality risk), and benefits are guaranteed by the Pension Benefit Guaranty Corporation. Otherwise, the cash balance plan functions like a defined contribution plan from the perspective of a participant.

Questions have been raised regarding whether and how cash balance plans satisfy the rules relating to age discrimination and the calculation of lump sum distributions.

Age Discrimination. Code section 411(b)(1)(H) provides that a defined benefit plan fails to satisfy the benefit-accrual rules if, under the plan, a participant's benefit accrual is ceased, or the rate of a participant's benefit accrual is reduced, because of the attainment of any age. Section 204(b)(1)(H) of the Employee Retirement Income Security Act of 1974 (ERISA) and section 4(i)(1)(A) of the Age Discrimination in Employment Act (ADEA) set forth similar rules.

Age-discrimination questions have been raised regarding two aspects of cash balance plans. First, some have argued that pay credits for younger participants provide higher benefits than the same pay credits for older participants because the pay credits for younger participants accrue interest credits over longer periods. Although one federal district court has agreed with this analysis, others have rejected it. Compare Cooper v. IBM Personal Pension Plan, 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (cash balance plan found age-discriminatory) with Campbell v. BankBoston, N.A., 206 F. Supp. 2d 70 (D. Mass. 2002) (cash balance plan found not age-discriminatory), aff'd, 327 F.3d 1 (1st Cir. 2003), and Eaton v. Onan Corp., 117 F. Supp. 2d 812 (S.D. Ind. 2000) (same).

Second, some have argued that "conversions" of traditional defined benefit plans to cash balance plans disadvantage older participants. A conversion occurs when a plan sponsor amends a traditional plan to make it a cash balance plan. A conversion can result in lower future accrual rates for some or all participants. If this occurs, ERISA section 204(h) and Code section 4980F require that participants receive advance notice. The conversion can also result in "wear-away" – a period following the conversion during which a participant's prior accrued benefits under the traditional plan exceed the benefits payable under the cash balance plan. Thus, during wear-away, the benefits under the cash balance formula of some or all participants must "catch up" with benefits accrued under the traditional plan. Wear-away may occur for the normal retirement benefit, the early retirement benefit, or both. However, under Code section 411(d)(6) and ERISA section 204(g), the conversion may not reduce the accrued normal or early retirement benefit of any participant.

Some have argued that the adverse effects of cash balance conversions fall more heavily on older participants than on younger participants because traditional plans usually provide more valuable accruals to older and longer-service participants. Many plan sponsors have adopted strategies to mitigate these effects, including protection of participant expectations through "choice" and "grandfathering" as well as avoidance of wear-away. However, these strategies have been voluntary, as current law generally gives the plan sponsor broad authority to amend a plan for any reason at any time. Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 443 (1999).

In December of 2002, Treasury and the IRS proposed regulations to address these and other age-discrimination issues. 67 Fed. Reg. 76123 (Dec. 11, 2002). The proposed regulations provide that a cash balance formula is not discriminatory as long as pay credits for older participants are equal to or greater than pay credits for younger participants. The proposed regulations also provide that cash balance conversions are not discriminatory as long as the conversions satisfy one of three permissible methods specified in the regulations. The proposed regulations do not prohibit reductions in future accrual rates or benefit wear-away because, under the conditions specified in the proposed regulations, those effects are not inherently age-discriminatory.

Calculation of Lump Sum Distributions. Three federal appellate courts have addressed the calculation of lump sum distributions under cash balance plans.

Berger v. Xerox Corp. Retirement Income Guarantee Plan, 338 F.3d 755 (7th Cir. 2003); Esden v. Bank of Boston, 229 F.3d 154 (2d Cir. 2000), cert. dismissed, 531 U.S. 1061 (2001); Lyons v. Georgia-Pacific Salaried Employees Retirement Plan, 221 F.3d 1235 (11th Cir. 2000), cert. denied, 532 U.S. 967 (2001). All three courts held that a participant's hypothetical account balance must be projected to normal retirement age using the plan's interest crediting rate, converted to an annuity, and then discounted to a lump sum using the section 417(e) interest rate. If the plan's interest crediting rate is the section 417(e) rate, the present value of the normal retirement age annuity will be the same as the hypothetical account balance. However, if the plan's interest crediting rate is higher than the section 417(e) rate, the present value of the normal retirement age annuity – and the amount of any lump sum distribution – will be greater than the hypothetical account balance. This result is sometimes referred to as "whipsaw."

These federal court decisions have followed an analysis set out in IRS Notice 96-8. Many plan sponsors have responded to whipsaw by limiting the interest crediting rate to the section 417(e) rate (or a deemed equivalent). This response effectively makes the section 417(e) rate a ceiling on plan interest credits.

Reasons for Change

Although cash balance plans and cash balance conversions are not inherently age-discriminatory, current law does not provide adequate protection for older workers in every conversion. For example, the statutory age-discrimination rules do not prevent a plan sponsor from changing future benefit accruals. Also, current law does not prevent a plan sponsor from imposing wear-away of normal or early retirement benefits. (Current law actually restricts certain transition practices, such as preserving the value of early retirement subsidies through additions to participant account balances.) Many plan sponsors have voluntarily tried to mitigate any adverse effects that cash balance conversions may have on older and longer-service participants. However, ensuring the fair treatment of older and longer-service participants in conversions requires strengthening current law to guarantee reasonable transition protections and to prohibit benefit wear-away.

Inconsistent federal court decisions make it necessary to clarify that cash balance plans are not inherently discriminatory as long as older participants are treated at least as well as younger participants. Removing uncertainty about the basic legality of cash balance plans is critical to preserving the vitality of the defined benefit system, which provides retirement income security for millions of American workers and their families.

As applied by the courts, the whipsaw effect under Notice 96-8 has harmed participants by leading plan sponsors to limit interest credits to the section 417(e) rate. This results in lower retirement accumulations for participants. The whipsaw effect should be eliminated so that plan sponsors can give participants higher interest credits.

Proposal

The proposal would accomplish three major objectives:

1. Ensure fairness for older workers in cash balance conversions.

2. Protect the defined benefit system by clarifying the status of cash balance plans.

3. Remove the effective ceiling on interest credits in cash balance plans.

Ensure fairness for older workers in cash balance conversions. The proposal would provide new protections for participants in cash balance conversions that would ensure fair transitions from traditional plans to cash balance plans. For each of the first five years after a conversion, the benefits earned by any current participant under the cash balance plan would have to be at least as valuable as the benefits the participant would have earned under the traditional plan if the conversion had not occurred. Additionally, there could be no wear-away of normal or early retirement benefits for any current participant at any time.

To prohibit violations of the new transition protections, there would be a 100 percent excise tax, payable by the plan sponsor, on any difference between the benefits required under the proposal and the benefits actually provided by the cash balance plan. In recognition of the fact that some plan sponsors may be experiencing adverse business conditions, the amount of the excise tax could not exceed the greater of the plan's surplus assets at the time of the conversion or the plan sponsor's taxable income. Failure to implement the new transition protections would not result in disqualification of the plan.

The excise tax would not apply if participants were given a choice between the traditional formula and the cash balance formula or if the cash balance conversion grandfathered current participants under the traditional formula. This would preserve flexibility of plan sponsors to implement other provisions that protect older and longer-service participants.

<u>Protect the defined benefit system by clarifying the status of cash balance plans</u>. The proposal would clarify that a cash balance plan satisfies the age-discrimination rules if the plan provides pay credits for older participants that are not less than the pay credits for younger participants, in the same manner as any defined contribution plan. The proposal would also clarify that certain transition strategies used in conversions (such as preserving the value of early retirement subsidies) do not violate the age-discrimination or other qualification rules. The proposal would provide similar rules for other types of hybrid plans and for conversions from traditional plans to other types of hybrid plans.

<u>Remove the effective ceiling on interest credits in cash balance plans.</u> The proposal would eliminate whipsaw, providing that a cash balance plan may distribute a participant's account balance as a lump sum distribution as long as the plan does not credit interest in excess of a market rate of return. The Secretary would be authorized to provide safe harbors for what constitutes a market rate of

return and to prescribe appropriate conditions regarding the calculation of plan distributions. This would permit plan sponsors to give higher interest credits to participants, resulting in larger retirement accumulations.

Conforming amendments and effective date. There would be conforming amendments under ERISA and the ADEA for statutory changes to the existing age-discrimination and distribution rules (but not for the new excise tax).

All changes under the proposal would be effective prospectively. The legislative history would state that there would be no inference as to the status of cash balance plans or cash balance conversions under current law.