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General Explanations  
of the  
Administration's Fiscal Year 2005  
Revenue Proposals

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Department of the Treasury  
February 2004

## **STRENGTHEN THE EMPLOYER BASED PENSION SYSTEM**

### **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); *Esdén 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.<sup>40</sup> 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.

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<sup>40</sup> The General Accounting Office reported that 84 percent of the employers that it surveyed provided full or partial transition relief in cash balance conversions. General Accounting Office, *Private Pensions: Implications of Conversions to Cash Balance Plans* at 33 (GAO/HEHS-00-185, Sept. 29, 2000); General Accounting Office, *Cash Balance Plans: Implications for Retirement Income* at 34-5 (GAO/HEHS-00-207, Sept. 29, 2000).

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.

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

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

**Revenue Estimate**

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Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	005-14
(\$'s in millions)							
0	0	0	0	0	0	0	2,373