

Client Alert

Treasury Proposes New Legislation On Cash Balance Plans

Yesterday, the Treasury Department proposed new legislation on cash balance plans. In a press release announcing the proposed legislation, Treasury Secretary John Snow notes:

“This proposal will make sure that every company converting to a cash balance plan deals fairly with its older workers. 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 plan 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 workforce.”

Cash balance plans are traditional pension plans that have been redesigned to look like individual account pension plans, such as 401(k) plans. Traditional pension plans typically offer benefits based on a formula which count a worker’s final average pay and length of service. Traditional pension plans generally favor older workers who remain with one company for a long time. Cash balance plans provide benefits based on hypothetical pay and earnings credits under hypothetical individual accounts for workers. Cash balance plans generally favor more mobile workers who accrue bigger benefits earlier in their careers and take their cash balance pensions with them when they change jobs. Most cash balance plans are created by converting an existing traditional pension plan to a cash balance plan.

Cash balance conversions have been criticized as treating older workers unfairly by providing lower benefits overall and by stopping benefit accruals for workers for a period of time under a concept called “wear-away.” After a traditional pension plan has been converted to a cash balance plan, cash balance plans typically stop workers from accruing additional benefits under the new formula for a period of time until the new benefits “catch up” with the benefits the workers carried forward from the traditional pension plan. This catch-up concept is known as “wear-away.”

In December 2002, the Treasury Department proposed rules for cash balance plans (see “Employee Benefits & Executive Compensation” Newsletter, December 2002), including rules on cash balance conversions. In July of 2003, a federal district court in Illinois ruled

that IBM's cash balance plan discriminated against older workers (see "Employee Benefits & Executive Compensation" Newsletter, Summer 2003). Other federal district courts have reached the opposite conclusion. In response to public outcry and the growing uncertainty over the legal status of cash balance plans in general, lawmakers recently voted to block the rules the Treasury Department issued in December 2002. As a result, the Treasury Department has proposed the new legislation for cash balance plans.

Proposed Legislation for Cash Balance Conversions

The proposed legislation is designed to provide fairness for older workers affected by cash balance conversions in two ways. First, the proposed legislation would impose a five-year "hold harmless" period. For five years after a conversion, the converted cash balance plan must provide *all* workers with benefits equal to the greater of (1) the value of benefit under the plan if the conversion had not taken place, and (2) the benefit under the new cash balance formula. After the five-year period, the new cash balance formula could apply. Second, the proposed legislation would impose a complete ban on "wear-away" formulas, to ensure that *all* workers begin accruing benefits immediately after the conversion.

To enforce the requirements imposed by the proposed legislation, a 100 percent excise tax would be imposed on any shortfall between the benefits required by the proposed legislation and the benefits actually provided under the cash balance plan. The excise tax would not apply to a company which gives workers a choice between the traditional pension plan and the new cash balance plan, or to a company which grandfathers all current employees under its traditional pension plan.

Proposed Legislation for All Cash Balance Plans

The proposed legislation would also clarify that cash balance plans do not discriminate on the basis of age "as long as they treat older workers at least as well as younger workers." It is hoped that the proposed legislation will provide more guidance on what this means.

Finally, the proposed legislation would eliminate what is called the "whipsaw effect" caused by existing IRS limits on interest credits that cash balance plans may now provide to workers. The proposed legislation would permit companies to give higher interest credits – which could increase retirement benefits for workers.

Conforming Amendments and Effective Date

If the proposed legislation becomes effective, additional conforming amendments would be required under ERISA and ADEA.

The proposed legislation would not become effective until it is enacted and would be effective for periods after the enactment.

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The initial reaction to the proposed legislation has been mixed. Some have criticized the proposed legislation as leaving too many unanswered questions and offering little or no protection for older workers affected by existing cash balance plans. Others view the proposed legislation more favorably, since it would provide companies with a workable framework to follow and would apply prospectively.

At this time, it is too early to tell whether the proposed legislation will be enacted in its current form and how it will impact the use of cash balance plans. As additional details of the proposed legislation become available, companies will be in a better position to assess the potential impact the proposed legislation may have on their plans. We will keep you apprised of any further developments on the proposed legislation.

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For Additional Information

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