IRS Gives Green Light To Cash Balance Plans

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The Internal Revenue Service has issued proposed rules on age discrimination in cash balance plans. Before the proposed rules were issued, many companies were wary of adopting cash balance plans in light of the potential age discrimination issues and the moratorium the IRS has imposed on issuing determination letters for certain types of cash balance plans.

The proposed rules make it easier for companies to offer cash balance plans. Many sponsors of existing cash balance plans will find that their plans meet the requirements of the proposed rules. In addition, the proposed rules provide detailed guidance on converting existing traditional defined benefit pension plans to cash balance plans. As a result, many companies may consider converting their traditional pension plans to cash balance plans.

These proposed rules are not without controversy. Many companies find that cash balance plans are more suitable for younger, more mobile workers and are often less costly, saving companies hundreds of thousands of dollars per year. However, many labor advocates have attacked cash balance plans as being unfair to older workers, particularly when existing traditional pension plans are replaced with cash balance plans. Although the proposed rules may not end the controversy, the proposed rules open the door for companies to sponsor cash balance plans with the blessing of the IRS.

It has been reported that, since the moratorium was placed by the IRS on issuing determination letters for cash balance plans in 1999, approximately 300 letters by companies seeking approval of their cash balance plans and pension plan conversions have been awaiting approval. In Announcement 2003-1, the Internal Revenue Service stated that any technical advice on pension plan conversions will not be processed until the rules become final. After the rules become final, it is expected that there will be a major shift to cash balance plans due to the demand of companies who have been seeking IRS clarity.

Comparison Of Traditional Pension Plans And Cash Balance Plans

Traditional Pension Plans. Under a traditional defined benefit pension plan, an employee receives a retirement benefit of a fixed amount typically based on the employee's salary and years of service. This method of determining a benefit allows an employee to accrue a significant portion of his or her benefit in the employee's final years of service (as compensation and years of service increase).

New Or Non-Converted Cash Balance Plans. A cash balance plan allows an employee to accrue benefits evenly over the course of his or her career. Typically, the benefit in a cash balance plan is equal to a "hypothetical account balance" comprised of certain annual additions equal to a percentage of an employee's annual compensation (called "pay credits") and earnings

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(called "interest credits"). A younger employee's account will generally yield a higher rate of benefit accrual than that of an older employee, because the younger employee has more years over which to accrue earnings.

Converted Cash Balance Plans. In many cases, traditional defined benefit pension plans are converted to cash balance pension plans. In a typical conversion of a traditional defined benefit pension plan to a cash balance plan, the cash balance plan provides an opening hypothetical account balance for each employee. In some plans, the opening balance is based on the employee's prior accrued benefit under the traditional pension plan. In other plans, the opening balance is set at zero and the employee is entitled to the sum of the employee's accrued benefit under the traditional pension plan and the cash balance account. In some conversions, an employee's opening account balance and subsequent interest credits through retirement age in the new cash balance plan generate benefits that are not as large as the prior accrued benefit under the old defined benefit plan. As a result, an employee may not accrue any additional benefits under the cash balance plan for some period after the conversion. This period, called a "wear-away" period, continues until the employee's account balance in the new cash balance plan exceeds his or her prior accrued benefit. Since many older workers have larger accrued benefits under traditional pension plans, older workers typically take longer to start accruing benefits under cash balance plans. As a result of the wear-away period, many labor advocates have alleged that converted cash balance plans discriminate on the basis of age.

How The Proposed Rules Work

The proposed rules address age discrimination issues for both new or non-converted cash balance plans and converted cash balance plans.

New Or Non-Converted Cash Balance Plans. In general, the proposed rules provide that a plan does not discriminate on the basis of age if the plan provides older workers with pay credits that equal or exceed the pay credits provided to younger workers. In more technical terms, the proposed rules would permit an "eligible" cash balance plan to provide a benefit accrual rate using additions to a hypothetical account, excluding regular interest credits attributable to previous accruals. Eligible cash balance plans must meet certain requirements: (1) the normal form of benefit must be an immediate payment of the hypothetical account (without regard to whether such immediate payment is actually available under the plan); (2) at the time that an employee accrues an addition to his or her hypothetical account, the employee must also accrue the right to future interest credits at a reasonable rate of interest that does not decrease because of age; (3) such interest credits must be provided for all future periods, including after normal retirement age; and (4) the plan cannot treat such interest credits after normal retirement age as actuarial increases that are offset against required accruals.

Converted Cash Balance Plans. The IRS addressed the wear-away issue for converted cash balance plans by requiring that converted cash balance plans satisfy one of two alternative rules. The first alternative requires that the converted plan determine each employee's benefit as not less than the sum of the employee's benefit accrued under the prior defined benefit plan and the cash balance account. Under this alternative, there is no wear-away. The second alternative requires that the converted plan establish each employee's opening account balance as an amount not less than the actuarial present value of the employee's prior accrued benefit, using reasonable actuarial assumptions. An interest rate assumption is not treated as reasonable if it increases because of an employee's age. If these requirements are met, then the second alternative will permit a wear-away period for some or all of the employees in the plan.

Other Guidance. The proposed rules also provide guidance on age discrimination requirements for defined benefit plans other than cash balance plans and for defined contribution plans, such as 401(k) plans, target benefit plans and profit-sharing plans and cross-testing of cash balance plans.

Effective Date

The proposed rules are subject to public comment for ninety days before they may be put into final form. The final rules will apply to plan years beginning after the IRS publishes the final rules, which are expected to be published in 2003. Once the rules are finalized, the IRS will lift its moratorium on issuing determination letters with respect to converted cash balance plans.

Action

Cash balance plan sponsors should review their existing plans to ensure that they meet the requirements of the proposed rules. Companies may wish to evaluate their existing traditional benefit plans to determine the advantages and disadvantages of converting to a cash balance plan and to determine whether the new guidance will benefit their existing traditional benefit plan.

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