



Pension and Employee Benefit Law
Toll Free (888) 489-9904

Cash Balance Plans: Terminology, Advantages and Disadvantages to Employers and Employees

More Americans than ever are concerned with financing their retirement. Employers who offer employee pension and benefit plans are equally concerned with the impact of employee retirement and how best to meet changing business pressures. The IRS recently completed a comment period seeking guidance on whether a certain type of pension plan, known as a "cash balance plan" violate federal law. The response was strong, with more than 500 comments – mostly from individual plan participants.

Now that the comment period is over, the next move belongs to the IRS. It is clear, however, that both employees and employers will be hearing more about cash balance plans in the days to come. Lawyers who represent participants in cash balance plans, or businesses who propose offering cash balance plans or seek to convert existing pension plans to cash balance plans, would be well served to understand these plans as well as their advantages and disadvantages. As well as outlining some advantages and disadvantages of cash balance plans, this article seeks to provide some basic information on the jargon of pension and employee benefits law.

Basic Terminology

Federal law requires employers who choose to offer pension plans to act in certain ways. For example, the Internal Revenue Code ("IRC") requires that pension plans be administered in particular ways in order to qualify for preferential tax treatment. The Employee Retirement Income Security Act ("ERISA") requires that the employer act as fiduciary with respect to plan administration and operate the plan solely for the benefit of the participants. The Age Discrimination in Employment Act ("ADEA") requires that employers not discriminate against employees based on age. Of course, all three of the laws mentioned above have many other provisions to which the employer must adhere.

In addition to knowing which laws are applicable to a discussion on pensions and employee benefits, it is important to understand certain commonly used terms. Under ERISA, two basic types of private pension plans exist: defined benefit plans and defined contribution plans.

A defined benefit plan is a pension plan usually funded entirely by employer contributions. The employee will receive a pension defined by a formula upon reaching a specified age. Once the employee reaches the specified age, the plan "vests" and the benefits due to the employee may not be reduced. Defined benefit plans are, in most cases, guaranteed by the Pension Benefit Guarantee Corporation ("PBGC") which pay out pension benefits should an employer's defined benefit plan become insolvent. Thus, with a defined benefit plan, the employer bears the investment risk and reward as all fund contributions are pooled.

A defined contribution plan is a typically funded by contributions of money from an employee and, in some cases, also by the employer. A plan which qualifies under Section 401(k) of the IRC - the "401(k) plan" - is the most well known form

of defined contribution plan. While the employer acts as plan administrator, and may charge a fee for administration of the plan, the employee bears the risk and reward from investment of the plan assets as each defined contribution account is, in most cases, specific to the individual. Defined contribution plans are not typically guaranteed by the PBGC.

The Cash Balance Plan

A cash balance plan is often erroneously referred to as a hybrid plan, because it is perceived as having elements of both a defined benefit and defined contribution plan. Cash balance plans are really defined benefit plans.

Cash balance plans are administered through hypothetical accounts. As with all defined benefit plans, the employer manages a pool of assets established by the employer. However, each employee receives a periodic statement stating his current account "balance". The hypothetical account balance is determined pursuant to a formula consisting of two credits paid into the fund by the employer: contribution credits (or wage credits) and interest credits. A contribution credit is regular payment by the employer to the hypothetical account based on a formula (generally a percentage of the employee's pay). An interest credit is a guaranteed rate of return credited at regular intervals to the hypothetical account by the employer. The interest credit is generated by a formula pegging the rate of return to a market index (such as the yield on 30 year treasury bonds, etc).

Cash balance plans, unlike typical defined benefit plans, are subject to shorter vesting periods and, generally, are portable. That is, when an employee changes jobs, she receives a pay out, either lump sum or an annuity, of the present value of the hypothetical account.

The employer-sponsor of a cash balance plan bears the investment risk and reward. Under current accounting standards, the profits earned by a company's qualified pension plan constitutes an asset of the company.

The Pros and Cons of Cash Balance Plans from the Employee's Perspective

From the employee's perspective, a cash balance plan is beneficial where the employee expects to be changing jobs frequently or at an early age. Under traditional defined benefit plans, benefits may not vest until relatively late in the employee's service with the company and the employee must serve until a normal retirement age until full benefits vest.

On the other hand, the benefits paid under a cash balance formula is typically less lucrative than the benefits paid under a traditional defined benefit plan. Cash balance formulas are based on a percentage of yearly income and, thus, include the employee's worst earning years as well as his best. Traditional defined benefit calculations are based on the employee's final years of service, when the employee's salary is usually at its greatest. Further, the employer keeps the profits exceeding the interest credit earned by a cash balance plan so an employee would never obtain the investment return possible through a 401(k) plan.

Employee's may also see a negative affect on their benefits where their employer converts from a traditional defined benefit plan to a cash balance plan. Often associated with the conversion is a so-called wear away or plateauing effect that freezes an employee's ability to accrue new benefits for a period of time. Wear away or plateauing occurs when an employee's vested benefits, which the employer must pay, under an old defined benefit plan formula exceed the benefits the same employee would have received under the new cash balance plan formula, had the cash balance formula been in place since the beginning of the employee's service with the company. Under many cash balance plans, the employee would stop accruing new benefits (i.e. the employer would make neither contribution credits nor interest credits to the employee's hypothetical account) until the present value of the employee's vested benefits under the old formula equaled the present value of the employee's vested benefits under the

cash balance formula. Consequently, during the wear away period, the employee experiences no growth in her hypothetical account. Accordingly, should the rate of inflation exceed zero percent, the employee will actually suffer a deemed loss in value of her benefits. It is this issue, the lack of any growth during the wear away period, which the IRS is currently reviewing. Wear away will mostly affect those employees who were close to vesting fully in a the company's old traditional defined benefit plan at the time of conversion.

The Pros and Cons of Cash Balance Plans from the Employer's Perspective

The allure of the cash balance plan for the employer is two-fold. First, the employer obtains a predictable payment stream to retired employees and all the funds needed to pay the retired employee are segregated into hypothetical accounts ear marked for the employee. Second, the fund retains all of the profits of the plan in excess of the interest credit. Thus, if the interest credit owed is 5% but the plan earned a 15% return, the employer would keep the 10% spread.

The disadvantage of a cash balance plan is, like a traditional defined benefit plan, the employer bears the downside risk of investment loss. Thus, if the interest credit is 5%, but the plan earns only a 1% return, the employer must make up the difference. However, of greater significance are the legal problems that may likely accompany the establishment of, or conversion to a cash balance plan.

Legal Problems with Cash Balance Plans

Currently the most significant problem with cash balance plans is conversion. As noted above, the "wear away" or "plateau" effect results in the employee's hypothetical account earning no return during the wear away period. If the wear away effect constitutes a deemed loss of accrued benefits, the conversion may

constitute a breach of fiduciary responsibility under ERISA. In Internal Revenue Bulletin 1999-79, the IRS specifically requested comments on whether wear away violates federal tax, pension or discrimination law. How the IRS responds – or does not respond – to the comments will factor substantially in the debate over the future of conversions to cash balance plans.

As with all overfunded plans, the fund retains the profits earned above the interest credit amount. As a result, under current accounting standards, the employer can recognize a benefit from using the preferential tax treatment of plan assets as an investment vehicle. Accordingly, the IRS may take issue with employers deriving profits from a principal amount on which they took a tax deduction.

A further potential area of concern may occur where the cash balance plan fund underperforms the market. Stock holders may claim, by way of a derivative suit, that the underperformance constitutes a breach of duty based on current prudent investment rules. Stock holders may claim that the fund, by underperforming the market, had a negative impact on the company's share price and, therefore, the company's mismanagement of the fund reduced the value of the stock. This is the logical extension of the fact that a well performing cash balance plan will directly benefit the corporate bottom line and stock holders.

Conclusion

The growing popularity of cash balance plans presents employers, employees and their attorneys with complex questions. There is little law giving guidance on the area of cash balance plans, particularly with regard to the wear away that often accompanies conversion to a cash balance plan. The IRS should provide guidance improving the quality of available information. If not, the issues will be left to the court system to decide, which will likely take many years of protracted litigation.

Copyright 2000, Moukawsher & Walsh, LLC