Order Code RS22214
Updated May 16, 2008

CRS Report for Congress

Cash Balance Pension Plans: Selected Legal Issues

Jennifer Staman and Erika Lunder
Legislative Attorneys
American Law Division

Summary

Over the past few years, cash balance pension plans have received significant congressional and public attention. Issues that have been controversial include the negative effect of a plan conversion on older employees due to wear-away, the whipsaw effect that may occur when computing a lump-sum payment of benefits prior to normal retirement age, and the practice of providing the "greater of" benefit to plan participants as part of a conversion to a cash balance plan. This report provides an overview of these issues and a discussion of how the Pension Protection Act (P.L. 109-280), as well as IRS guidance, affect them.

In the past several decades, plans have been developed that are modifications of the traditional defined benefit plan.[1] These plans are referred to as *hybrid* plans because they are defined benefit plans that conceptualize the benefits in a manner similar to defined contribution plans.[2] One type of hybrid plan is the cash balance plan. A cash balance pension plan is a defined benefit plan that resembles a defined contribution plan because the employee's promised future benefits are stated as an account balance. The account is hypothetical (each participant does not actually have an account) and is used to reflect the amount of benefits the individual has accrued. The account consists of employer contributions that are a percentage of annual compensation (called pay credits) and interest earned on those contributions (called interest credits).

---

[1] A defined benefit plan is a pension plan under which an employee is promised a specified future benefit, traditionally an annuity beginning at retirement. In a defined benefit plan, the employer bears the investment risk and is responsible for any shortfalls. See ERISA § 3(35).

[2] A defined contribution plan is a pension plan in which the contributions are specified, but not the benefits. A defined contribution plan (also called "an individual account" plan) provides an individual account for each participant that accrues benefits based solely on the amount contributed to the account and any income, expenses, and investment gains or losses to the account. See ERISA § 3(34).

An employer may choose to adopt a cash balance plan as a new retirement plan or may convert its traditional defined benefit plan to a cash balance plan. During the past two decades, numerous employers have converted or considered converting their plans. A conversion is subject to the rules that apply to any plan amendment, including the anti-cutback rule. Under that rule, an amendment may not (1) decrease an accrued benefit or (2) eliminate or reduce an early retirement benefit or retirement-type subsidy with regard to service that has already been performed, except in limited circumstances and with prior approval by the Treasury Secretary.[3] The plan amendment may only reduce future benefit accruals since these benefits have not yet been earned. Any amendment that significantly reduces the rate of future benefit accrual requires clearly-written notice to affected participants.[4]

Cash balance plans and other hybrid plans have been the subject of controversy. Three issues have received recent public and congressional attention: the negative effect of a plan conversion on older employees due to wear-away, the whipsaw effect that may occur when computing a lump-sum payment of benefits prior to normal retirement age, and the practice of providing the "greater of" benefit to plan participants as part of a conversion to a cash balance plan.[5] While the Pension Protection Act of 2006 (P.L. 109-280)[6] clarified the law with respect to cash balance plans and added various new requirements that these plans must meet, certain questions remain with respect to these three issues.

Wear-Away

In a conversion from a defined benefit plan to a cash balance plan, an employee's accrued benefit will typically be converted into a hypothetical opening account balance. If this opening account balance is less than the present value of the benefits the employee has already accrued, then the employee may experience a period of wear-away. Wear-away occurs during the time it takes the account balance under the cash balance plan to surpass the accrued benefit the employee has already earned under the defined benefit plan. During this period, an employer may not be required to make new contributions to an employee's cash balance plan account until the account balance catches up to the previously accrued benefit. Because of wear-away, an employee may have to work several years before accruing any additional pension wealth under the cash balance plan.[7] This issue, while still pertinent, has become somewhat less controversial due to changes made by the Pension Protection Act.

---

[3] ERISA § 204(g); ERISA § 302(c)(8); IRC § 411(d)(6); IRC § 412(c)(8).

[4] ERISA § 204(h)(1).

[5] Another controversial issue with respect to cash balance plans is the claim that cash balance plans and/or the conversion to such plans violate federal laws prohibiting age discrimination. This issue is addressed in a separate report. See CRS Report RL33004, *Cash Balance Pension Plans and Claims of Age Discrimination*, by Erika Lunder and Jennifer Staman.

[6] For a general discussion of the Act, see CRS Report RL33703, *Summary of the Pension Protection Act of 2006*, by Patrick Purcell.

[7] *See generally,* E.A. Zelinsky, *The Cash Balance Controversy*, 19 VA.TAX REV. 683, 702-03 (2000).

Critics have argued that the wear-away concept violates the anti-cutback rules of the Employee Retirement Income Security Act (ERISA). In *Campbell v. BankBoston*,[8] the First Circuit Court of Appeals addressed this issue and held that the occurrence of wear-away due to a conversion from a defined benefit plan to a cash balance plan did not violate the anti-cutback rules. The court stated that the anti-cutback rules protected Cambell's accrued benefits but not his future expected benefit. Therefore, according to the court, ERISA allowed BankBoston to amend or terminate future accruals so long as Campbell received the pension benefits previously accrued.

The Pension Protection Act of 2006 amended ERISA, the Internal Revenue Code (IRC), and the Age Discrimination in Employment Act (ADEA) to include new restrictions on plan conversions.[9] These restrictions are intended to eliminate the wear-away of pre-conversion benefits. The Act provides that when a traditional defined benefit plan is converted into a cash balance plan, each participant must receive the sum of (1) the pre-conversion accrued benefit determined under the prior plan formula plus (2) the post-conversion accrued benefit determined under the cash balance plan formula. A newly converted plan must also credit a participant with the amount of any early retirement benefits or retirement-type subsidies if the participant has met the requirements for the benefit or subsidy under the prior plan. The wear-away provision is applicable to plan conversions adopted after June 29, 2005. Thus, for plans that converted to a cash balance plan prior to this date, issues regarding wear-away still remain and may still be evaluated by the courts.[10]

Whipsaw

In general, cash balance plans are designed so that employees who leave employment prior to normal retirement age may receive a lump-sum payment of their accrued benefits at the time of termination, as opposed to waiting until normal retirement age. Depending on how the value of the lump-sum payment is determined, there may occur what is known as the whipsaw effect. The basic issue, arising prior to the enactment of the Pension Protection Act, is whether the lump-sum payment equals the current account balance or the present value of the accrued benefits expressed as an annuity beginning at normal retirement age.

In the past, some employees argued that the lump-sum payment must equal the present value of the accrued benefit expressed as an annuity beginning at normal retirement age. This is based on the argument that ERISA and the IRC require that a lump-sum payment of an accrued benefit in a defined benefit plan be the actuarial equivalent of that benefit, determined according to statutorily-prescribed interest rate and mortality assumptions.[11] Under this argument, the employee's lump-sum payment in a cash balance plan must be calculated by (1) projecting the hypothetical account balance

---

[8] Campbell v. BankBoston, 327 F.3d 1 (1st Cir. 2003).

[9] ERISA § 204(b)(5)(B)(ii); IRC § 411(b)(5)(B)(ii); ADEA § 4(i)(10)(B)(ii).

[10] See, e.g., Custer v. S. New Eng. Tel. Co., 2008 U.S. Dist. LEXIS 5067 (Jan. 24, 2008) (court dismisses plaintiffs' claims that effect of wear-away arising from a plan conversion violated various provisions of ERISA).

[11] ERISA § 203(e); IRC §§ 411(a) and 417(e).

to normal retirement age by adding future interest credits, at the interest rate specified in the plan, to the account, (2) converting the balance to an annuity payable at that age, and (3) determining the present value of that annuity using the statutorily-prescribed interest and mortality assumptions. The lump-sum distribution is then the present value of the annuity. In 1996, the IRS released proposed guidance on how to compute the lump-sum payment under a cash balance plan and used this method.[12]

The whipsaw effect arises if the interest rate used to project the account balance to normal retirement age [the "projection rate"] is higher than the interest rate used to determine the present value of the annuity beginning at normal retirement age [the "discount rate"]. In such a situation, the value of the lump-sum payment (i.e., the present value of the annuity) will be greater than the employee's account balance. This result will be common if it is required that the projection rate be the rate specified in the plan for the interest credits. This is because many plans use an interest rate for the interest credit that is higher than the statutorily-prescribed discount rate.

Some employers argued that since the benefits of a cash balance plan are expressed as the employee's hypothetical account balance, the amount in the account should be distributed as a lump-sum payment. In other words, they claim the lump-sum distribution does not have to include the present value of the post-termination interest credits. Some of these employers have argued that the method outlined in the IRS proposed guidance is incorrect. Others have followed that method, but used the statutorily-prescribed discount rate as both the projection rate and the discount rate. This method results in the value of the lump-sum payment equaling the current value of the employee's hypothetical cash balance account.

Prior to the Pension Protection Act, three U.S. courts of appeals had considered the issue, and all three held that ERISA required plans follow the procedure described in the IRS proposed guidance and use the plan's interest rate as the projection rate.[13] For many plans, this meant that the lump-sum payment was required to be greater than the amount of the hypothetical account balance at termination.

The Pension Protection Act of 2006 contains a provision intended to eliminate the effects of whipsaw.[14] Under the Act, a cash balance plan may pay out to an employee a lump sum distribution equal to the participant's hypothetical account balance. The Act requires that the plan must use a market rate of interest to calculate the lump-sum (as opposed to the 30-year Treasury rate under prior IRS guidance). The whipsaw provision applies to distributions made after August 17, 2006.[15] Thus, litigation may still ensue regarding lump sums paid to employees before the Act was passed.

---

[12] IRS Notice 96-8, 1996-1 C.B. 359 (Feb. 5, 1996).

[13] Berger v. Xerox Corp. Retirement Income Guarantee Plan, 338 F.3d 755 (7th Cir. 2003); Esden v. Bank of Boston, 229 F.3d 154 (2nd Cir. 2000); Lyons v. Georgia-Pacific Salaried Employees Retirement Plan, 221 F.3d 1235 (11th Cir. 2000).

[14] ERISA § 203(f); IRC § 411(a)(13).

[15] The Treasury Department has issued proposed regulations that would provide guidance for calculating a market rate of return. See 72 Fed. Reg. 73680 (Dec. 28, 2007).

Cash Balance Conversions and the "Greater Of" Transition

One method of plan conversion from a traditional defined benefit plan to a cash balance plan involves calculating the benefit for employees under both the traditional defined benefit plan formula, as well as the cash balance formula, and then providing benefits under whichever formula that yields the greater amount, either on a permanent or temporary basis. While this "greater of" method has been considered a favorable option for employees, it has been publicized that the IRS, in issuing determination letters to employers who converted their plans, indicated that using this two-formula method could violate rules designed to prevent an employer from "backloading" a participant's benefit accruals (i.e., providing disproportionately higher benefit accruals to participants for later years of service than for earlier years). ERISA and the IRC provide that defined benefit plans must satisfy one of three benefit accrual rules,[16] and the regulations accompanying these rules provide that when a plan has multiple benefit formulas available to a participant, a plan must aggregate these formulas in order to determine whether one of three permissible accrual rules have been satisfied.[17] The IRS allegedly took the position that if a plan used both the traditional defined benefit plan and the cash balance plant formulas simultaneously, an impermissible spike or drop in the accrual rate of a participant's benefits could result.[18]

While the Pension Protection Act addressed plan conversions from a traditional defined benefit plan to a hybrid plan, such as a cash balance plan, it did not require or prohibit any specific conversion methods. However, in February 2008, the Treasury Department and IRS issued Revenue Ruling 2008-7,[19] which addressed how the accrual rules apply to a "greater of" scenario. Under the facts of the ruling, as part of a conversion from a traditional defined benefit plan to a cash balance plan, participants who met certain age and service requirements were "grandfathered" into the traditional defined benefit plan, while other employees began participating in the new cash balance plan. In its analysis, plan participants were split into various groups, including (1) those who were employed after the plan conversion and would only receive benefits under the new plan; (2) those who received benefits under the old plan, and benefits under the new plan, as

---

[16] Under section 204 of ERISA and section 411(b) of the IRC, a defined benefit plan must meet one of three benefit accrual rules. The rule most applicable to cash balance plans is the 133-1/3 rule, which generally requires that a later rate of accrual for one year of plan participation cannot be more than 133-1/3 percent of the rate for any other plan year. Other tests include the fractional rule, under which an employee's accrued benefit upon separation from service is proportional to the annual benefit commencing at normal retirement age. Finally, under the 3% method, a participant must accrue at least 3% of the participant's normal retirement benefit of which the participant would be entitled if the participant began participating in the plan at the earliest possible age and served continuously until the earlier of (1) age 65 or (2) the normal retirement age as specified under the plan, up to a maximum of 33-1/3 years.

[17] Treas. Reg. § 1.411(b)-1(a)(1).

[18] One example where this result could occur is if an employee is temporarily grandfathered into the old plan. Once the employee is switched to the new plan, there may be a large drop in the benefits accrued by the employee in the year of transition. See Carol H. Jewett and Felicia A. Finston, *Recent Additions, Cash Balance Conversions and Other Greater of Formulas*, available at [http://www.bnatax.com/tm/insights_jewett.htm].

[19] Rev. Rul. 2008-7, 2008-7 I.R.B. 419 (Feb. 1, 2008).

they did not meet the age and service requirements imposed by the plan; and (3) those who were "grandfathered" into the old plan. The ruling concluded that the plan satisfied one of the three accrual rules with regard to each group of participants. An important part of the ruling's explanation includes the idea that while benefit formulas must be aggregated for determining whether a plan meets the accrual rules, all participants in the plan do not have to satisfy the same accrual rule, so long as one of the three permissible rules for each participant group is satisfied.[20]

The ruling also provides temporary relief from plan disqualification (i.e., a loss of favorable tax status) for other cash balance plans that provide "greater of" benefits, so long as the benefits provided under each plan formula, standing alone, meet one of the accrual rules. This temporary relief is only available to plans that have received a favorable determination letter and meet certain other conditions. According to the ruling, plans that meet these conditions will not be considered as violating the accrual rules until January 1, 2009. The Treasury Department and IRS have issued a press release indicating that they anticipate proposing amendments to the regulations dealing with the situation presented in the revenue ruling, as well as other similar "greater of" formulas. It is anticipated that the regulations will apply to plan years beginning in 2009.[21]

---

[20] See Carol H. Jewett and Felicia A. Finston, *Recent Additions, Cash Balance Conversions and Other Greater of Formulas*, available at [http://www.bnatax.com/tm/insights_jewett.htm].

[21] Press Release, U.S. Treasury, Treasury, IRS Provide Guidance on Backloading in Pension Plans (Feb. 1, 2008).