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Cash Balance Pension Plans: Selected Legal Issues

Erika Lunder
Legislative Attorney
American Law Division
Jennifer Staman
Law Clerk
American Law Division

Summary

Over the past few years, cash balance pension plans have received significant attention. In particular, three issues have been controversial: 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 claim that these plans violate federal laws prohibiting age discrimination. This report discusses the wear-away and whipsaw issues, a proposal by the Treasury Department that addresses them, and relevant legislation introduced in the 109th Congress (H.R. 2830 and S. 1304). For information on the age discrimination issue, see CRS Report RL33004, *Cash Balance Pension Plans and Claims of Age Discrimination*.

Federal laws, including the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC), distinguish between two types of pension plans: defined benefit plans and defined contribution plans.[1] In a defined benefit plan, an employee is promised a future benefit that is traditionally expressed as an annuity beginning at normal retirement age. The annuity is typically determined by a formula that factors in the employee's years of service and the average salary of his or her highest salaried years. In a defined contribution plan, the employee is promised that the employer will currently make a specified contribution to the employee's pension account. The contribution is generally a percentage of the employee's salary.

A cash balance plan is a hybrid pension plan in that it is a defined benefit plan that looks like a defined contribution plan because the employee's promised future benefits are stated as his or her account balance.[1] The account is hypothetical (i.e., each employee does not actually have an account), but is used to conceptualize the amount of benefits the

[1] For more information, see CRS Report RL30196, *Pension Issues: Cash-Balance Plans*, by Patrick Purcell.

employee has accrued. The account reflects contributions equaling a percentage of salary (called pay credits) and interest earned on those contributions (called interest credits).

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.[2] The plan amendment may reduce future benefit accruals since these benefits have not yet been earned. This reduction may include ceasing benefit accrual for a period of time. Any amendment that significantly reduces the rate of future benefit accrual requires clearly-written notice to affected participants.[3]

Wear-away

In a conversion from a defined benefit plan to a cash balance plan, an employee's accrued benefit may be converted to a hypothetical opening account balance. If this opening account balance is lower than the present value of the benefits the employee has already accrued, then he or she may experience a period of wear-away.[4] 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.[5]

There can be wear-away of normal retirement benefits and/or early retirement benefits and retirement-type subsidies. Wear-away of normal retirement benefits occurs when the opening account balance in the cash balance plan is less than the present value of the employee's accrued benefits expressed as a pension benefit beginning at normal retirement age. Wear-away of early retirement benefits and subsidies occurs when the opening account balance is less than the present value of the employee's accrued benefits

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

[3] ERISA § 204(h)(1).

[4] There are several situations in which the opening account balance may be less than the accrued benefits under the old plan. For example, if the opening balance represents the lump sum distribution of the employee's accrued benefits under the old plan, the IRS requires that the defined benefit lump sum be calculated using the interest rate for 30-year Treasury bonds. This interest rate may be lower than the plan funding rate, which can translate into a cash balance plan account balance that is less than the employee's accrued benefit under the old plan. Furthermore, an employer is not required to calculate an opening account balance in a cash balance plan based on an employee's previously accrued benefit under the old plan. The opening account balance can be zero if an employer so chooses, in which case the employee receives the accrued benefits under the old plan and the benefits accrued under the cash balance plan.

[5] *See generally* E.A. Zelinsky, The Cash Balance Controversy, 19 Va.Tax Rev. 683, 702-03 (2000).

expressed as a pension benefit that reflects the early retirement benefits and subsidies. Thus, while the anti-cutback rules prohibit an employee from losing an early retirement benefit or subsidy attributable to service before the amendment, the expected early retirement benefits or subsidies offered under a traditional defined benefit plan may be worn away in the same manner as normal retirement benefits.

Critics have argued that the wear-away concept violates the anti-cutback rules of ERISA. In one of the few cases to examine cash balance plans and the concept of wear-away, *Campbell v. BankBoston*, the First Circuit Court of Appeals 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.[6] In this case, BankBoston converted its defined benefit plan to a cash balance plan. The cash balance plan contained a benefit safeguard provision which ensured that long-term employees would receive the greater of the cash balance plan amount or the amount that would have been received under the defined benefit plan. Several years later, BankBoston amended the cash balance plan and removed the benefit safeguard provision. Employees then maintained opening account balances based on the present value of their accrued benefits at the time of the amendment. If an employee had accrued a greater benefit under the old defined benefit plan than the amount of the opening account balance, an employee's pension entitlement would not grow until the account balance surpassed the previously accrued benefit.[7]

Campbell, a long-term employee of BankBoston, earned no new benefit amount between the time of plan conversion and his retirement. Campbell claimed that this ceasing of benefit growth due to the plan conversion amounted to a forfeiture in violation of ERISA's anti-cutback rules. The Court of Appeals disagreed, holding that the anti-cutback rules protected Campbell's accrued benefits, but not Campbell's future expected benefits.[8] Under ERISA, BankBoston had the ability to amend or terminate future accruals, so long as Campbell received the pension benefits previously accrued.[9]

Finally, while this report does not address the age discrimination claims, it should be noted that critics have also argued that the wear-away concept is inherently age discriminatory because it is more likely for older workers to have higher opening account balances than younger workers. It does not appear that any court has accepted this argument. For more information, see CRS Report RL33004, *Cash Balance Pension Plans and Claims of Age Discrimination*, by Erika Lunder and Jennifer Staman, at pages 6-15.

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 arise what is known as the whipsaw effect. The basic issue is whether the lump-sum payment equals the

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

[7] *See generally* Zelinsky, 19 Va. Tax Rev. at 703.

[8] *Id*. at 19.

[9] *Id*. at 18-19.

current account balance or the present value of the accrued benefits expressed as an annuity beginning at normal retirement age.

Some employees have 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.[10] Under this argument, the employee's lump-sum payment in a cash balance plan must be calculated by (1) projecting the hypothetical account balance 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.[11]

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 the statutorily-prescribed discount rate.

Some employers have 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.

Three U.S. courts of appeals have held that plans must follow the procedure in the IRS proposed guidance and use the plan's interest rate as the projection rate.[12] For example, in *Berger v. Xerox Corp. Retirement Income Guarantee Plan*, the U.S. Court of Appeals for the Seventh Circuit rejected the company's arguments that the value of a lump-sum payment could equal the hypothetical account balance on the date of distribution. In the Xerox plan, the interest credit was the average one-year Treasury bill

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

[11] IRS Notice 96-8 (Feb. 5, 1996).

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

rate for the prior year plus 1%. In determining the value of a terminating employee's lump-sum payment, the plan used the statutorily-prescribed rate as both the projection rate and the discount rate.[13] Employees who terminated employment and chose to receive a lump-sum distribution of their accrued benefits prior to reaching normal retirement age received the amount in their cash balance accounts as of the date of distribution. Former employees sued, alleging that the plan's method of using the same rate as both the projection and discount rates violated ERISA.

The court held that the plan had to use the rate specified in the plan for the interest credits as the projection rate. It rejected Xerox's argument that the employees' entitlement to future interest credits terminated when they chose to take a lump sum distribution and, therefore, they were only entitled to the account balance on the date of distribution. Instead, the court reasoned that since a terminating employee was entitled to an annuity beginning at normal retirement age which included the interest credits, an employee who chose to take his or her accrued benefits prior to reaching normal retirement age had to receive a distribution that was actuarially-equivalent to that annuity.[14] Thus, a lump-sum payment had to include the present value of those credits. The court also stated that the IRS notice that prescribed a procedure that reached this result was "an authoritative interpretation of the applicable statutes and regulations."[15] The court went on to note that if the company believed its argument that the employees were only entitled to their account balances, "it would not go through the motions of first projecting future credits at the [statutorily-prescribed] rate and then discounting them at the same rate to present value . . . ."[16] The court further stated that because the company's method meant that employees who chose the immediate distribution gave up their right to an annuity at normal retirement age that included the interest credits, the employees were basically "being invited to sell their pension entitlement back to the company cheap, and that is a sale that ERISA prohibits."[17]

Treasury Department's Proposal

In 2004, the Treasury Department announced a legislative proposal that would address the wear-away and whipsaw issues.[18] First, it would prohibit the wear-away of normal and early retirement benefits. A plan that violated this would be subject to a

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[13] As the court noted, because both the interest rates would vary, it is not clear that this method would always result in the whipsaw effect.

[14] Berger, 338 F.3d at 761.

[15] *Id*. at 762.

[16] *Id*. at 761.

[17] *Id*. at 762.

[18] Treasury Department Press Release JS-1132 (Feb. 2, 2004), which is available at [http://www.treas.gov/press/releases/js1132.htm]. The proposal would also create a new age discrimination test for cash balance plans and require, for the first five years after a conversion, the benefits earned under the cash balance plan be no less than the benefits that would have been earned under the old plan. In addition to the proposal, the Treasury Department has taken other actions with respect to the cash balance issue, including proposing and then withdrawing regulations. For more information, see CRS Report RL33004, *Cash Balance Plans and Claims of Age Discrimination.*

penalty tax that equals 100% of the difference between the benefits required under the proposal and the benefits actually provided, limited to the greater of the plan's surplus assets at the conversion or the plan sponsor's taxable income. There would be no penalty if participants were given a choice between the two plans or if current participants were grandfathered under the old plan's formula. Second, the proposal would end whipsaw. Under the proposal, the lump-sum distribution of an employee's benefit prior to reaching normal retirement age could equal the amount in the employee's hypothetical account, so long as the plan did not credit interest at an above-market level. The proposal would apply prospectively and would not be intended to create an inference as to the status of cash balance plans or conversions under current law. It has been included in the revenue provisions of the Administration's budget proposals for fiscal years 2005 and 2006.[19]

Legislation Introduced in the 109th Congress

H.R. 2830. In June of 2005, Congressmen John Boehner, Sam Johnson, and Bill Thomas introduced H.R. 2830, the Pension Protection Act of 2005, to update several areas of pension law.[20] One of the ways that the act could affect the legal issues discussed in this report is through new requirements for calculating lump-sum distributions. As discussed, under current law, a defined benefit plan is generally required to provide employees' accrued benefits in the form of an annuity, but can offer to provide these benefits as a lump sum amount that is actuarially-equivalent to that annuity. The act would change the interest rate that is used in calculating this lump sum amount, from a 30-year Treasury rate to varying interest rates as provided under the funding rules of ERISA and the IRC. These interest rates would reflect the yields on investment grade corporate bonds and increase or decrease based upon the number of years existing before an annuity could be paid out.

S. 1304. The Pension Benefits Protection Act of 2005 would impose requirements on any employer whose conversion to a cash balance plan had the effect of reducing the rate of future benefit accrual for at least one participant. The act would require that the employer allow employees who are at least 40 years old or have at least 10 years of service under the plan the option at retirement of receiving benefits under the traditional or cash balance plan. The employer would also be required to provide these employees with a comparison of their present and projected accrued benefits under both plans. Additionally, the act would include a provision to prohibit wear-away of both normal and early retirement benefits in plans with at least 100 participants. The act would apply to all converted plans, unless the IRS had approved the conversion before June 24, 2005. Plans that had converted prior to or within 90 days of the act's enactment would have 90 days after the act's enactment to comply with the new requirements.

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[19] The proposal for FY2006, found in the *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals* on pages 81-84, is available at [http://www.treas.gov/offices/tax-policy/library/bluebk05.pdf].

[20] For a general discussion of the act, see CRS Report RS22179, *H.R. 2830: The Pension Protection Act of 2005*, by Patrick Purcell. A companion bill, H.R. 2831, was also introduced. This bill amends the age discrimination provisions of ERISA and the IRC and establishes a standard for testing whether cash balance plans are age discriminatory.