

Are Cash-Balance Plans Really Dead?

by Stephen H. Rosen, EA, CPC

Abstract: *After many years of uncertainty, the IRS and Treasury have stepped up and, from their perspective, have clearly resolved the cash-balance dilemma. In December 2002, the Treasury released final regulations that gave the pension community long-awaited guidance on how to design and administer cash-balance plans. While employers, attorneys and actuaries were still in the process of analyzing those regulations and determining how to incorporate those guidelines within the plans that were already in place, a number of unanticipated events immediately pushed cash-balance plans even further back into the world of confusion than where they were to begin with.*

Cash-balance plans are not new. They've been around since the mid-1980s, soon after BankAmerica pioneered the concept. However, for years there has essentially been no guidance other than what can be gleaned from a handful of private letter rulings, revenue rulings, IRC Section 401(a)(4), and the regulations that were ultimately published in 1993 and amended in 2001.

Class action lawsuits (most notably, against IBM and Xerox) began hitting the presses with a surprisingly new focus on an issue that never seemed to concern the IRS when it issued its final regulations: age discrimination. Up until now, the courts have been clearly sympathetic to the claims of employees, especially older ones, as a reaction to employer-sponsored pension plans being converted into cash-balance designs. Prospective benefit accruals for older employees, especially when compared to those formulated for younger employees, are frequently less than what was structured under the original pension plan arrangement. Though employers should not be expected to make promises or guarantees to their employees relating to those benefit accruals, nor to the ongoing future existence of the entire pension plan for that matter, the fact that they may now be "discriminating" against older employees in the cash-balance approach results in an apparent concern for the impact of ERISA and the Age Discrimination in Employment Act of 1967 on that type of plan design.

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The fact that defined-contribution plans are typically structured to accrue benefits in a fashion comparable to cash-balance plans does not seem to alleviate that concern. In fact, a cash-balance plan is an attractive alternative to the age-weighted defined-contribution model that became popular in the mid-'80s.

The greatest concern identified by Congress, governmental agencies, and the courts relating to age discrimination in retirement plans has been primarily focused on cash-balance plans that have been converted from a traditional defined-benefit form. Separate from the manner in which benefits accrue and are funded on a prospective basis, the actuarial technique developed at the point of conversion to "allocate" a plan's past service liabilities into hypothetical account balances can create distinct discrimination issues. Until there has been guidance and resolution in the conversion arena, it would be advisable for planners to utilize a conservative approach to this design opportunity. Of course, if a cash-balance design is being considered merely as a start-up opportunity for an employer, without the burden of creating a methodology to transfer a predecessor plan's assets or liabilities into a successor plan, this entire concern is alleviated.

Though cash-balance arrangements are under scrutiny by the court system, decisions that are reached have relevance only within the jurisdictions that are governed by those decisions. Congress and Treasury have opted to follow a similar line of thinking to that of the courts, making the current adoption of cash-balance plans much riskier. In fact, Congress has remanded Treasury to withdraw the final cash-balance regulations so that no further guidance or approvals can be given indefinitely. However, as recently as February 2 of this year in the President's budget proposal, Treasury continued to support the concept of cash balance as a vehicle to promote retirement security among American workers.

So, what does all that say about the future of cash-balance plans? And where do we turn with plans that are already in existence? One would hope that this issue would get resolved sooner rather than later, but in the meantime, what should employers do?

To make that decision and to assess the inherent risks of pursuing cash-balance plan designs, it is valuable to review their pros and cons. In addition, if an employer is already sponsoring a qualified retirement plan, the issue of transitioning from the current arrangement to a cash-balance plan needs to be addressed from legal and public relations perspectives. For example, if the current plan is of the defined-contribution variety, those issues may not be as problematic, unless the level of benefits under the new cash-balance arrangement are less than under the defined-contribution design. In that situation, a focused communication program for the employees that highlights the benefits of the change would be critical. However, if the cash balance is an amendment to an existing defined-benefit plan, anti-cutback considerations and all of the notice requirements applicable to them would need to be addressed. It is under this scenario that the current controversy of the conversion process comes into play. Grandfathering accrued benefits and including a "wear-away" approach would not be a sufficient solution. However, granting participants the ability to select or just giving them the higher accrued benefit formula on an ongoing basis likely would be.

So, what are the pros and cons of cash-balance plans? Clearly, in today's marketplace, cash balance meets many objectives of effective plan design, both for the employer and the employee.

From the employer's perspective, cash-balance design better addresses the mobile and shorter-tenured workforce by offering more meaningful benefit accruals in the early years of an individual's career. Traditional pension plans are generally "back-loaded" and based on a final salary average, both of which allow employers to skew benefits toward the older and longer-term employees. Today's employers are generally more inclined to attract and reward younger employees, even if there is a higher likelihood that they will not retain them for a long period of time. Cash-balance plans can be designed to accomplish that objective without burdening the employer with high plan costs that often accompany traditional pension plans.

From the employee's perspective, participating in a retirement program with formulated guarantees has a great deal of appeal during this post-Enron era of benefit insecurity. Clearly, the industry is dramatically shifting away from the support of defined-benefit plans due to their complicated and inflexible funding and liability rules. Cash balance, if developed responsibly by our legislators, regulators and consultants, could become the solution to our currently fractured defined-benefit system. Not only does the employee derive a benefit of the employer's ongoing funding obligations, but he/she is also assured a fixed return on that investment. In addition, through the use of hypothetical account balances, which include employer contributions and interest credits, it is easier for the employee to understand the value of the benefits being promised.

What this means is that a cash-balance design is often the most appropriate plan design in meeting a specific employer's overall objectives. Its appropriateness reinforces the need for its continued existence!

The selection of the interest rate that is set forth in the plan document becomes a critical design consideration since it is credited to the hypothetical accounts of each participant of the cash-balance plan. Though IRS guidelines clearly identify the range of interest rates that can be used for this purpose (7.5%-8.5%), the rates required when calculating the present value of accrued benefits for payout purposes are subject to a different set of guidelines. As of the press date for this issue, those payout calculations were governed by IRC Section 417(e), employing rates related to the 30-year Treasury rate (which, coincidentally, no longer exists in the marketplace). However, it appears that legislation providing for a higher blended corporate bond rate may be enacted. This inconsistency between rates used for accruals versus payouts can ultimately lead to a difference in the benefits illustrated in the hypothetical account balance of a terminated or retired participant when compared to his or her actual lump sum entitlement from the plan. It is for this reason that it is often customary for the interest rate that is selected for crediting purposes to closely mirror the 417(e) requirements.

In developing an investment policy for a cash-balance plan, one needs to be mindful of the 417(e) requirements, at least on a long-term basis. Since cash-balance plans are generally designed to allow for lump-sum distributions and the accrued benefit calculations are directly related to the current 417(e) interest rates, it is advisable that the plan's investment model mirror those rates as accurately as possible. Otherwise, the plan sponsor would be faced with unexpected fluctuations in the plan's ongoing contribution requirements, like any other defined-benefit plan. If the cash-balance design were to become permanent, new forms of investment products would ultimately evolve that were benefit sensitive and would generate returns that simulated long-term bond rates. A modified approach to traditional guaranteed investment contracts could be one of those alternatives.

Within the pension community, there continues to be a history of forward-thinking plan design taking precedence over lagging regulatory guidance. For example, though it may have been simpler and less stressful for practitioners to wait for final and comprehensive guidance when cross-tested defined-contribution plans first became popular, the progressive approach was to proceed with such a plan design, though on a somewhat cautious track. Those employers who were appropriate candidates for cross-tested arrangements indeed benefited from that creativity, especially now that the design has been developed, tested, and approved.

Interestingly, the cross-tested design is the fundamental basis for nondiscrimination issues surrounding cash-balance plans, and the unresolved issues surrounding the latter are comparable to the set of rules that have already been codified and regulated for cross-tested plans. So, for those who understand the current state of affairs and are willing to take the appropriate risks, cash-balance plans should be considered as a viable design option, even today.

After the risks of adopting a cash-balance plan have been assessed and, of course, assuming that the design fits the employer's demographics and benefit objectives, there are a number of other issues that should be addressed before the actual commitment is made. First

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of all, it should not be overlooked that cash-balance plans are of the defined-benefit variety, which presents an added layer of attention that does not apply to defined-contribution plans. For example, minimum funding requirements apply on an ongoing basis, suggesting that the cash-balance candidate would need to have consistent and predictable cash flow, something that is more difficult to expect in today's economic climate. In addition, since it is not just the funding of accrued benefits that is guaranteed by the employer, but the added cost of accepting the plan's investment risk, many employers may be unable (or unwilling) to cope with the added burden. In addition, the Pension Benefit Guaranty Corporation (PBGC) becomes a further cost and liability factor if the employer is other than a small professional organization.

Administrative costs associated with the operation of a retirement plan should be considered separately as well. Due to the significant commitment already being made by the financial industry to the defined-contribution marketplace, record-keeping functions are flexible, are competitively priced and are offered at varying levels. Actuarial services, which are separately required in the administration of cash-balance plans, need to be customized to fit the plan's design and need to be identified as a separate cost factor.

Even small employers are subject to financial reporting in accordance with generally accepted accounting principles. Depending upon the financial statement presentation that is dictated by the employer's bank, shareholders, customer base, etc., it may be necessary for the actuary to perform separate calculations and a valuation to conform to FAS 87 and 132. These disclosures may have an impact on the financial condition of an employer that may reach beyond the expected cost and tax considerations that are routinely associated with qualified retirement plans.

In the small plan marketplace, there is a unique opportunity for the cash-balance design. Since cash balance is of the defined-benefit variety, there is no specific dollar limitation that applies to the allowable funding for any specific individual when compared to

the rules for defined-contribution plans, only when applied to the 415 limitations for defined-benefit plans. More specifically, if there is an actuarial basis for funding a participant's accrued or projected benefit in an amount exceeding \$41,000 per year, it is allowable to allocate that contribution to the hypothetical account of a cash-balance plan. That opportunity is especially attractive to the employer who is capable of funding in excess of the defined-contribution limit on a routine basis, such as professional service businesses with predictable cash flow. Physician groups can be perfect candidates for this type of design. This is especially true where the professionals are working in a partnership environment, where each partner expects to fund the plan with a contribution that is consistent with his or her partnership percentage. For example, equal partners would be able to fund their cash-balance plan at the same dollar amount without regard to a difference in their ages. In addition, since cash-balance plans can satisfy the nondiscrimination requirements using the general test under IRC Section 401(a)(4), it would not be unusual for the minimum funding obligation attributable to the non-highly compensated group to be less than under the defined-contribution model. This becomes a win-win situation for the employer who is looking to maximize the contribution level for a specific individual(s) or group of employees at the least amount of cost in covering the remaining employees.

When employing the general test, it may be convenient to develop a variety of contribution rate groups to achieve an employer's design needs that are derived from multiple job classifications. Since it is reasonable to expect an employer to have differing objectives among various employee groups, this may be an attractive option to consider merely from that perspective. In fact, with creative structuring of rate groups, the general test yields even more attractive results than under a safe-harbor testing method. The cash-balance design illustration presented in the Appendix reflects not only the opportunity to utilize a spread of rate groups among different employees, but also the ability to customize the employee groupings themselves.

In conclusion, the unique qualities of a cash-balance plan do have their place in the array of design options available to an employer. It is important that the current climate of regulatory uncertainty and lack of overall guidance, as well as the defined-benefit nature of cash-balance plans, is considered during the feasibility and decision-making process. The ability for employers to contribute at levels in excess of the defined-contribution limits, fund for employees' benefits at a predictable and often less costly level than under traditional plans, and customize a benefit structure across varying employee groups creates a retirement program for the progressive and dynamic employer. ■

Stephen H. Rosen is a graduate of Rutgers University, an enrolled actuary, a Certified Pension Consultant, and a member of the American Academy of Actuaries. He currently serves as president-elect of ASPA and is a founding member of the ASPA Benefits Council of the Delaware Valley.

Steve coauthored the books, *Tax Reform Act* and *Accountant's Guide to Employee Benefit Plans*, as well as articles in *Taxation for Accountants* and the *Pennsylvania CPA Journal*. Steve served on the faculty at the Institute of Employee Benefits in Philadelphia and has been a frequent lecturer on retirement plan issues. He can be reached at steve@shrosen.com.

APPENDIX

Example of a Cash-Balance Plan Design

Employee	Age	Compensation	Cash Balance and Contribution Credit	Percentage of Compensation
HCE-1	55	\$200,000	\$100,000	50%
HCE-2	50	200,000	100,000	50%
HCE-3	48	200,000	40,000	20%
NHCE-1	40	50,000	10,000	20%
NHCE-2	41	45,000	9,000	20%
NHCE-3	54	35,000	1,750	5%
NHCE-4	39	35,000	7,000	20%
NHCE-5	33	35,000	1,750	5%
NHCE-6	35	30,000	6,000	20%
NHCE-7	34	20,000	1,000	5%
NHCE-8	31	20,000	1,000	5%
NHCE-9	29	<u>19,000</u>	<u>950</u>	5%
		\$889,000	\$278,450	
			% of Total	
	HCE Total	\$240,000	86.19%	
	NHCE Total	\$38,450	13.81%	
		\$278,450	100.00%	

HCE, highly compensated employee (generally earning in excess of \$90,000); NHCE, non-highly compensated employee.