An “Okay” for Cash Balance Conversions

BACKGROUND

While over the past decade many employers have chosen to offer employees 401(k) and other defined contribution retirement plans over more-costly defined benefit pension plans, some employers that had pension plans have opted for the more compromising route of converting those pension plans to cash balance plans. A cash balance plan is structured so that it combines some of the best features of a defined benefit and a defined contribution plan.

Generally, defined benefit plans do not feature account balances like in a defined benefit plan. With a cash balance plan, the employer creates a hypothetical account for each participant which is credited annually with a percentage of the participant’s annual pay (the “pay credit”). The percentage of pay credited on behalf of participants depends on the formula used by the employer. For example, the percentage may be fixed or it may vary with years of service.

The plan sponsor promises to pay a specified interest rate (the “interest credit”) on contributions to the plan. Generally, this rate is tied to the rate on Treasury securities. Thus, like a defined benefit plan, the sponsor guarantees the benefit the participant will receive at retirement. Unlike with a defined contribution plan, the plan sponsor bears the risk that the plan assets could earn less than the credits accumulated in participants’ hypothetical accounts. If that happens, the sponsor has to make up the difference.

Note, though, that in cash balance plans, participant account balances are merely on paper until the participant retires or leaves the company. The employer contributions in the plan asset pool are invested in securities chosen by the sponsor. Participants receive regular statements showing the accumulated balances in their accounts but do not have the right to direct investments. When participants retire or change jobs, they can roll over the amounts they have accrued into an IRA or another employer’s plan or leave the money in the cash balance plan where it will continue to earn the stated interest rate.

THE CONTROVERSY

Some plan sponsors who converted pension plans to cash balance plans were met with lawsuits brought by older employees charging age discrimination. Hence, the IRS moratorium on determination letters until final regulations covering age discrimination are issued.

A general principle of qualified retirement plans is that a qualified defined benefit plan may not reduce a participant’s benefit accruals on account of age, regardless of whether the participant has reached the plan’s normal retirement age. Similarly, qualified defined contribution plans cannot reduce benefit allocations based on age. However, plans can limit the amount of benefit or the number of years of service counted for participation without violating the age discrimination rules.

Since younger participants have more future years over which to compound earnings than older participants, cash balance plans yield higher benefit accrual rates at younger ages when measured on the same basis as traditional defined...
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benefit plans. If a plan sponsor does not take this into account when converting a plan, older participants can wind up with less than they would have received through a traditional pension plan, in which benefits are weighted to favor the final years of work.

NEW GUIDELINES

The proposed regulations include specific direction on avoiding age discrimination when converting a pension plan to a cash balance plan. They require that a participant’s opening account balance in the cash balance plan be at least the actuarial present value of his or her prior accrued benefits. Any excess opening balance over the actuarial present value must be treated as an accrual for purposes of meeting the age discrimination requirements.

If the converted balance is less than the accrued benefit under the traditional defined benefit pension plan, a participant may not accrue any new benefits until the participant’s hypothetical account balance exceeds the value of benefits accrued under the traditional pension’s formula. As long as a conversion has satisfied the rules for determining the opening balance and for applying the age discrimination rules, this so-called “wear-away” period will not violate the age discrimination rules.

The proposed regulations also allow certain cash balance plans to follow the cross-testing method, outlined in new comparability regulations*, that allows plans to satisfy nondiscrimination requirements based on plan contributions instead of plan benefits. To test on a contribution basis only, the plan’s normal retirement benefit must be expressed as the hypothetical account balance with future interest credits regardless of future service. The cash balance plan also must satisfy a “minimum allocation gateway.” The allocation rate for nonhighly compensated employees must be at least 5% of compensation or one-third the highest allocation rate for highly compensated employees.

CARE NEEDED

Plan sponsors who are considering converting their pension plans to cash balance plans should proceed with care. The IRS will apply the proposed regulations only to plan years that begin after it publishes the final regulations. Until then, the IRS will continue its moratorium on determination letters on the qualification of cash balance plans. Employers that currently sponsor cash balance plans should prepare for the final regulations by reviewing their plan design with their employee benefits advisor to ensure it complies with the proposed regulations. If you would like to learn about how we can help implement and administer a cash balance plan, contact us.

Choosing a Default Investment

Studies show that most plan sponsors choose a single diversified default fund arrangement for employees who fail to direct the investment of their retirement account assets.

What type of fund do they choose? A recent survey by the Profit Sharing/401(k) Council of America (PSCA) found that stable value funds are the most popular default investment choice. However, the PSCA notes a rising trend among plan sponsors to designate balanced funds or lifestyle funds as their plans’ default investment.

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<th>Percent of Sponsors Using Choice</th>
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<tr>
<td>Stable Value Fund</td>
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<tr>
<td>Balanced Fund</td>
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<tr>
<td>“Other” including Lifestyle Funds</td>
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<tr>
<td>Money Market Account</td>
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Source: Profit Sharing/401(k) Council of America, www.psca.org


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RECENT DEVELOPMENTS

EBSA

The U.S. Department of Labor’s (DOL) Pension and Welfare Benefits Administration (PWBA) has been renamed the Employee Benefits Security Administration (EBSA).

Certain breaches of fiduciary duty that are being corrected under the DOL’s Voluntary Fiduciary Correction (VFC) Program also may avoid IRS excise taxes under a new prohibited transaction class exemption created by the EBSA. These breaches include: (1) late transmittal of employee contributions and participant loan repayments to plans, (2) market-interest-rate loans by plans to parties in interest, (3) purchases or sales of assets between plan and related parties at fair market value, and (4) sale and leaseback of property between plans and employers for fair market value and fair market rental value.

IRS

According to a recent IRS ruling, a qualified pension, profit sharing, or stock bonus plan that has been amended to use the Economic Growth and Tax Relief Reconciliation Act of 2001’s increased compensation limit to determine benefits for all former employees or all former employees who retain accrued benefits under the plan (as well as current employees) satisfies the nondiscrimination and minimum coverage requirements of the Internal Revenue Code. This $200,000 compensation limit applies to plan years after December 31, 2001 (Rev. Rul. 2003-11, 12/20/2002).

The IRS has released final regulations on loans from qualified employer plans to plan participants and beneficiaries. The final regulations retain the general structure of the proposed regulations released in 2000, with a few changes. Under the proposed regulations, if a participant had more than two loans outstanding during a year, the entire amount of all of the loans was treated as a deemed distribution taxable to the participant. The final regulations eliminate this limitation. They also permit a plan to suspend loan repayments during a participant’s military leave of absence without having the loan treated as a deemed distribution and generally adopt the proposed regulations on loan refinancing. A refinancing is treated as a continuation of the prior loan plus a new loan to the extent the loan balance is increased. The new amount may be repaid over as long as five years, but the outstanding balance of the old loan generally must be paid over the remaining original loan period. Also, under the final regulations, if a loan is deemed distributed to a participant and is not repaid, the participant may not apply for another loan unless the participant and the plan enter into an agreement that provides for either repayment of the new loan by payroll deductions or adequate security for the loan. The final regulations were effective December 3, 2002, and apply to loans made on or after January 1, 2004 (Federal Register, December 3, 2002).

The IRS has issued two releases for defined benefit plan sponsors that should ease the burdens of complying with the required minimum distribution (RMD) regulations issued in spring 2002. Notice 2003-2 says that the IRS plans to issue final regulations in 2003 which will likely include a transition rule allowing defined benefit plans and annuities to make RMDs according to pre-2002 proposed regulations instead of the provisions in the 2002 final and proposed regulations. In addition, a second transition rule is expected that would permit the entire interest under an annuity contract to be determined without taking into account other benefits. Plan sponsors may rely on the RMD rules described in the notice until the IRS issues final regulations on these rules. Revenue Procedure 2003-10 postpones the time by which defined benefit plans must be amended to comply with the final and temporary RMD regulations issued in 2002. Under the 2002 regulations, all plan sponsors had until the last day of the first plan year beginning on or after January 1, 2003, to amend their qualified plans. Now, defined benefit plan sponsors do not have to amend their plans to comply with the final and temporary RMD regulations until the end of the Economic Growth and Tax Relief Reconciliation Act’s remedial amendment period — the last day of the first plan year beginning on or after January 1, 2005.

In a private letter ruling, the IRS has given a green light to an arrangement that allows employees to exchange the value of up to five days of unused sick leave for an employer contribution to a 401(k) plan. Employees do not have an option to receive cash or other taxable benefits in lieu of the plan contribution. (continued on back)
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According to the IRS, this arrangement does not result in actual or constructive receipt of income to the employees eligible to participate. Nor does the plan contribution constitute a salary deferral under a cash or deferred arrangement or wages for purposes of FICA withholding. Rather, it is a nonelective employer contribution (L.R. 200247050).

**STATS**

Market conditions may be taking a toll on participants’ investment confidence. According to a 2002 poll conducted by Harris Interactive, 76% of employees agree that they don’t know enough about investing their retirement plan accounts, compared to 65% in 2001. A significantly higher percentage (61%) would prefer to have their investments managed by an outside expert than did in 2001 when 45% preferred to rely on someone else. About a third of those surveyed strongly agree that they would like their employer to provide more information or advice about reaching retirement goals (2002 Transamerica Small Business Retirement Survey).

Not surprisingly, a recent human resources survey indicates that allowing plan participants access to their plan accounts online reduces the number of call center calls. Those surveyed reported 31% fewer calls after implementing online benefit services. Internet access also changes the type of center calls, with participants using online access for simpler transactions and calling with more complex questions and transactions or for assistance completing online transactions. According to the survey, 93% of 401(k) plan sponsors offer participants online access to their account balances along with transaction services, 89% had online enrollment, and 63% gave participants the ability to use the Internet to change personal data (2002 HR Service Delivery Survey, Towers Perrin).

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