Cash Balance Pension Plans

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If your company is converting its traditional pension plan benefit formula to a new cash balance pension plan benefit formula, you may have some questions about how this change will affect you. The following are responses to some of the most often asked questions. These responses are designed to provide general information and are not legal interpretations of ERISA or the Internal Revenue Code. If you still have questions, call one of our offices or email your question to EBSA.

What is a Cash Balance Plan?

There are two general types of pension plans — defined benefit plans and defined contribution plans. In general, defined benefit plans provide a specific benefit at retirement for each eligible employee, while defined contribution plans specify the amount of contributions to be made by the employer toward an employee's retirement account. In a defined contribution plan, the actual amount of retirement benefits provided to an employee depends on the amount of the contributions as well as the gains or losses of the account.

A cash balance plan is a defined benefit plan that defines the benefit in terms that are more characteristic of a defined contribution plan. In other words, a cash balance plan defines the promised benefit in terms of a stated account balance.

How do Cash Balance Plans work?

In a typical cash balance plan, a participant's account is credited each year with a "pay credit" (such as 5 percent of compensation from his or her employer) and an "interest credit" (either a fixed rate or a variable rate that is linked to an index such as the one-year treasury bill rate). Increases and decreases in the value of the plan's investments do not directly affect the benefit amounts promised to participants. Thus, the investment risks are borne solely by the employer.

When a participant becomes entitled to receive benefits under a cash balance plan, the benefits that are received are defined in terms of an account balance. For example, assume that a participant has an account balance of $100,000 when he or she reaches age 65. If the participant decides to retire at that time, he or she would have the right to an annuity based on that account balance. Such an annuity might be approximately $8500 per year for life. In many cash balance plans, however, the participant could instead choose (with consent from his or her spouse) to take a lump sum benefit equal to the $100,000 account balance.

If a participant receives a lump sum distribution, that distribution generally can be rolled over into an IRA or to another employer's plan if that plan accepts rollovers.

The benefits in most cash balance plans, as in most traditional defined benefit plans, are protected, within certain limitations, by federal insurance provided through the Pension Benefit Guaranty Corporation.

How do Cash Balance Plans differ from traditional pension plans?

While both traditional defined benefit plans and cash balance plans are required to offer payment of an employee's benefit in the form of a series of payments for life, traditional defined benefit plans define an employee's benefit as a series of monthly payments for life to begin at retirement, but cash balance plans define the benefit in terms of a stated account balance. These accounts are often referred to as "hypothetical accounts" because they do not reflect actual contributions to an account or actual gains and losses allocable to the account.

How do Cash Balance Plans differ from 401(k) plans?

Cash balance plans are defined benefit plans. In contrast, 401(k) plans are a type of defined contribution plan. There are four major differences between typical cash balance plans and 401(k) plans:

a. **Participation -** Participation in typical cash balance plans generally does not depend on the workers contributing part of their compensation to the plan; however, participation in a 401(k) plan does depend, in whole or in part, on an employee choosing to make a contribution to the plan.
b. **Investment Risks -** The investments of cash balance plans are managed by the employer or an investment manager appointed by the employer. The employer bears the risks of the investments. Increases and decreases in the value of the plan's investments do not directly affect the benefit amounts promised to participants. By contrast, 401(k) plans often permit participants to direct their own investments within certain categories. Under 401(k) plans, participants bear the risks and rewards of investment choices.
c. **Life Annuities -** Unlike 401(k) plans, cash balance plans are required to offer employees the ability to receive their benefits in the form of lifetime annuities.
d. **Federal Guarantee -** Since they are defined benefit plans, the benefits promised by cash balance plans are usually insured by a federal agency, the Pension Benefit Guaranty Corporation (PBGC). If a defined benefit plan is terminated with insufficient funds to pay all promised benefits, the PBGC has authority to assume trusteeship of the plan and to begin to pay pension benefits up to the limits set by law. Defined contribution plans, including 401(k) plans, are not insured by the PBGC.

Is there a federal pension law that governs these plans?

Yes. Federal law, including the Employee Retirement Income Security Act (ERISA), the Age Discrimination in Employment Act (ADEA), and the Internal Revenue Code (IRC), provides certain protections for the employee benefits of participants in private sector pension plans.

If your employer offers a pension plan, the law sets standards for fiduciary responsibility, participation, vesting (the minimum time a participant must generally be employed by the employer to earn a legal right to benefits), benefit accrual and funding. The law also requires plans to give basic information to workers and retirees. The IRC establishes additional tax qualification requirements, including rules aimed at ensuring that proportionate benefits are provided to a sufficiently broad-based employee population.

The Department of Labor, the Equal Employment Opportunity Commission (EEOC), and the IRS/Department of the Treasury have responsibilities in overseeing and enforcing the provisions of the law. Generally, the Department of Labor focuses on the fiduciary responsibilities, employee rights, and reporting and disclosure requirements under the law, while the EEOC concentrates on the portions of the law relating to age discriminatory employment practices. The IRS/Department of the Treasury generally focuses on the standards set by the law for plans to qualify for tax preferences.

Are there requirements that apply if my employer converts my current plan to a Cash Balance Plan?

Yes; however, employers are not required to establish pension plans for their employees because the private pension system is voluntary. In addition, employers are allowed substantial flexibility in deciding whether to terminate or amend their existing plans. Therefore, employers generally may change by plan amendment their traditional pension plans and the benefit formulas they use.

Federal law does place restrictions on plan changes generally. For example, advance notification to plan participants is required if, as a result of the amendment, the rate that plan participants may earn benefits in the future is significantly reduced. Additionally, there are other legal requirements that have to be satisfied, including prohibitions against age discrimination. In addition, while employers may amend their plans to cease future benefits or reduce the rate at which future benefits are earned, they generally are prohibited from reducing the benefits that participants have already earned. In other words, an employee generally may not receive less than his or her accrued benefit under the plan formula at the effective date of the amendment. For example, assume that a plan's benefit formula provides a monthly pension at age 65 equal to 1.5 percent for each year of service multiplied by the monthly average of a participant's highest three years of compensation, and that the plan is amended to change the benefit formula. If a participant has completed 10 years of service at the time of the amendment, the participant will have the right to receive a monthly pension at age 65 equal to 15 percent of the monthly average of the participant's highest three years of compensation when the plan amendment is effective. This pre-amendment benefit (including related early retirement benefits) is protected by law and cannot be reduced.

In addition, there are additional restrictions that apply specifically in the case of an amendment that converts a plan formula to a cash balance plan formula. Specifically, participants must receive the sum of the pre-amendment benefit plus benefits under the new cash balance formula (as a result, there cannot be a "wear away" period during which the participant does not accrue additional benefits, as could occur if participants were merely entitled to the greater benefit). Furthermore, all benefits under a cash balance plan (including benefits accrued prior to a conversion) must be fully vested after 3 years of service.

What happens to the assets in a plan when an employer converts its traditional defined benefit plan formula to a Cash Balance Plan formula?

When an employer amends its plan to convert the plan's traditional defined benefit plan formula to a cash balance plan formula, the plan's assets remain intact and continue to back all of the pension benefits under the plan. Employers cannot remove funds from the plan, unless the plan has been terminated and has assets remaining after payment of all of the benefits under the plan.

How am I affected if I leave my job at a company that just changed its pension plan from a traditional defined benefit formula to a Cash Balance Plan formula?

If you have worked long enough to be vested under the plan, you should receive the sum of (1) the accrued benefit under the formula in effect before the amendment, and (2) the additional benefits (see response to question 6 above) you earned under the plan formula in effect after the amendment. However, you may have to wait until a retirement age under the plan to receive your benefit.

Is my employer required to give me a choice of remaining under the old formula rather than automatically switching me to the new Cash Balance Plan formula?

Neither ERISA nor the IRC requires employers to give employees the choice of remaining in the old formula. Employers have several options, including:

a. Providing no choice, replacing the old formula and applying the new formula to all participants.
b. Allowing employees to remain under the old formula, while restricting new hires to the new formula
c. Stipulating that certain employees who have reached a specific length of service or who have reached a certain age may choose to stay with the old formula

The law permits employers to have such flexibility, but whatever option applies has to satisfy legal requirements.

Under each of these options, benefits already earned by the participants, as of the effective date of the amendment that converts the old formula to a cash balance formula, may not be reduced.

What information is my employer required to give me to explain the new Cash Balance Plan formula, and when should I receive this information?

Many employers voluntarily provide helpful information about these conversions in advance of the change becoming effective. Make sure you have all the information that the employer has provided. If you are still not sure if you have enough information to understand the plan change, you have a right to contact your plan administrator and ask for more information or help in understanding the change and any choices you have in conjunction with the change.

Plan administrators are generally required to give at least 45 days' advance notice of plan amendments that significantly reduce the rate at which plan participants earn benefits in the future.

After the plan is amended, the plan administrator is required to provide all plan participants with a Summary of Material Modifications to the plan or a revised Summary Plan Description. This document will summarize the changes to your plan.

In addition, under the Age Discrimination in Employment Act (ADEA), an employer requiring an employee to sign a waiver of rights and claims when choosing between plans is required to provide enough information to enable the employee to make a knowing and voluntary decision to waive ADEA rights. In most cases, an employee must be given at least 21 days to sign the waiver and at least 7 days to revoke the agreement.

Will the conversion of my pension plan formula have an effect on my retiree health benefits?

Often, pension plans and health plans are operated independently and are administered separately. However, sometimes eligibility for retiree health benefits depends upon eligibility for pension benefits. If you have questions about your health benefits you should contact your health plan administrator. Be aware that, like pension plans, health plans generally can be amended or terminated.

What should I do if I believe my benefits under the old formula have been inappropriately reduced or that my rights have been violated?

You should immediately contact the plan administrator and discuss your concerns. Be sure to review your individual benefit statement or the information used to calculate your benefit to determine if it is correct — such as employment date, length of service, and salary.

If your concerns are not adequately addressed, or you still have questions about your situation, you should contact one of our offices.

In addition, employees who believe that they have been subject to discriminatory treatment because of their age, race, color, religion, sex, national origin, or disability may file a charge of discrimination with the Equal Employment Opportunity Commission (EEOC).