

Cash-Balance Retirement Plans: They're Back!

By Carolyn Hirschman, *October 2007*

[From SHRM Online's [Compensation & Benefits Focus Area](#)]

Remember cash-balance plans? These once-scorned retirement savings hybrids are poised to make a comeback from legal limbo, even as traditional defined-benefit pensions continue to decline, experts say.

Though the Internal Revenue Service has yet to issue final guidance, some big-name employers are converting fully or partially from traditional defined benefit pensions to cash balance plans. Among *Fortune* 100 companies, 27 have hybrid retirement plans, most of them cash-balance. As lingering legal issues are resolved, "We're going to see an increase in cash-balance plans. How big of an increase is hard to say," says Alan Glickstein of consultancy Watson Wyatt Worldwide.

Meanwhile, a growing number of profitable smaller companies, such as law firms and medical practices, are also re-discovering cash-balance plans to help business owners and partners to increase their tax-deferred savings.

*Smaller firms are adding hybrid plans to help owners
increase their tax-deferred savings.*

In their case, "The primary objective is to do additional retirement savings and tax sheltering beyond what a 401(k) can do," says Daniel Kravitz, president of Lou Kravitz & Associates, a third-party administrator in Encino, Calif. Of the firm's clients, 250 had cash-balance plans in 2007, compared with 150 in 2006.

How They Work

Although they fall under the rubric of "defined benefit," cash-balance plans use individual account features similar to 401(k)-style defined contribution plans. Many employees find these accounts easier to understand than traditional pension benefits calculated as an amount to be accrued at retirement.

According to the U.S. Department of Labor's [FAQs About Cash-Balance Pension Plans](#), here's how they operate:

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 affect the benefit amounts promised to participants directly. Thus, the investment risks and rewards on plan assets 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. Such an annuity might be approximately \$10,000 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.

In addition to generally permitting participants to take their benefits as lump sum benefits at retirement, cash balance plans often permit vested participants to choose (with consent from their spouses) to receive their accrued benefits in lump sums if they terminate employment prior to retirement age.

The key differences between cash-balance and 401(k) plans are that:

- Professionally managed cash-balance plans often get better investment returns than employee-controlled 401(k)s.
- Overfunded traditional defined benefit plans can transfer a surplus to a cash-balance plan but not to a defined contribution plan.
- If a cash-balance plan is terminated with insufficient funds to cover the promised payout, the PBGC has authority to assume trusteeship of the plan and to begin to pay pension benefits up to the limits set by law.

SHRM Video



Gary Kushner, president of Kushner & Co., discusses trends in retirement plans, including how cash-balance can be an attractive option for employers seeking to move out of the defined benefit arena.

[Watch video clip](#)

Clearing the Air

The [Pension Protection Act \(PPA\)](#) and [appellate court rulings](#) favorable to plan sponsors helped pave the way for a cash-balance comeback, after some lower courts had ruled that the plans discriminated against older workers.

Enacted in August 2006, the PPA for the first time clarified how to operate and convert to cash-balance plans. It declared conversions not to be age discriminatory if older workers' benefits are at least as high as benefits for younger workers with the same pay and tenure.

During the past few years, many courts have supported similar age-discrimination standards. Still, large employers are moving slowly as they assess their retirement plans in light of a new regulatory climate as well as recruiting, retention and financial needs.

“There are definitely some positive signs, but there is also some uncertainty,” says Jan Jacobson, director of retirement policy at the American Benefits Council, an employer group in Washington, D.C. “We are still waiting for guidance from the IRS and Treasury.”

The age-discrimination issue that unsettled many plan sponsors to begin with is mostly but not totally settled, benefits attorneys say. The PPA makes clear that cash-balance conversions after June 29, 2005, do not discriminate based on age. The law does not apply to older plans that make up the bulk of the market. For them, court rulings are the main guidance.

*The PPA makes clear that cash-balance conversions
 after June 29, 2005, do not discriminate based on age.
 For older plans, court rulings are the main guidance.*

“There are some areas of the country where it’s settled and others where it’s not,” says Peter M. Varney of law firm Alston + Bird LLP in Atlanta. Other areas—mostly in the South, the West and the Northeast—have had no lawsuits at all.

Three federal appeals courts have ruled that cash-balance conversions are not age discriminatory; a decision was pending in a fourth. The U.S. Supreme Court, which refused to hear the case against IBM Corp. in January 2007, might take a different cash-balance case if appeals courts disagree, but “it’ll be a while, if ever, before the Supreme Court gets involved,” Varney says.

The latest controversy—over whether the “greater of” benefit formula commonly used for older employees in conversions violates an old technical rule—has led Congress and industry groups to pressure the IRS to change its position. Pending that outcome, many experts don’t foresee any regulatory action that could derail future conversions.

“It usually takes one or two years for companies to study the issue,” says Cecil Hemingway, Aon Consulting’s retirement practice leader. “I think we’ll see more conversions in 2008 and after that.” There were an estimated 26,605 single-employer hybrid plans covering 34.2 million participants in 2005, according to the latest figures from the Pension Benefit Guaranty Corp. (PBGC).

Taking the Plunge

An increasing number of employers—including FedEx Corp., Dow Chemical Co., MeadWestvaco Corp. and SunTrust Banks Inc.—have taken the plunge recently, starting or announcing cash-balance plans while keeping their traditional pension plans and enhancing their 401(k)s.

Company	Participants and Effective Dates
Dow Chemical	New employees as of 1/1/08.
MeadWestvaco	New employees as of 1/1/07; current employees as of 1/1/08.
SunTrust Banks	New employees and current employees with more than 20 years, as of 1/1/08.
FedEx Corp.	New and current employees as of 6/1/08.

Different employers are taking different approaches, however. For example:

- FedEx Corp. will freeze its defined benefit plan for new and current employees in mid-2008 and expand its four-year-old cash-balance plan.

- MeadWestvaco, a 24,000-person global packaging company, in 2007 launched a cash-balance plan for new hires. Other employees will join the plan on Jan. 1, 2008. Employees who are 40 or older have the option of remaining in the existing, traditional defined benefit pension plan.
- Dow Chemical Co.'s 1,200 or so expected new U.S. hires will join a new cash-balance plan starting in 2008, but its 22,000 current employees may remain in the traditional defined benefit pension plan.
- Similarly, at SunTrust new hires will be eligible for the new cash-balance plan in January 2008, while current employees have the option of remaining in the traditional defined benefit plan.

Many employers that replace their traditional defined benefit plans fully or partially with cash-balance plans have provided supplemental defined contribution 401(k)s to their employees and will continue to do so, including the four companies noted above. Many, in fact, are increasing their contributions into the 401(k) to make the overall retirement package more appealing.

Another point to bear in mind: The rationale for jettisoning traditional defined benefit plans isn't just cost savings, which might or might not materialize with a cash-balance conversion (although cash-balance plans help considerably in terms of managing the risk of larger-than-expected unfunded liabilities).

“Offering a cash-balance formula as part of our ongoing pension plan allowed us to modernize our pension plan and provide a simpler, more portable benefit,” says Alison von Puschendorf, a spokeswoman for MeadWestvaco, based in Richmond, Va.

“SunTrust wanted a retirement program that would keep us competitive in the marketplace and be financially sustainable for the long term. We believe that the combination of the cash-balance defined benefit plan and the enhanced 401(k) will provide value for all employees, no matter where they are in their careers,” explains company spokesman Hugh Suhr.

A Viable Option

As the above examples suggest, with legal and regulatory obstacles largely gone, cash-balance plans are now considered a viable option for plan sponsors that are considering freezing or terminating a traditional defined benefit plan and beefing up their 401(k) plans.

“You will see them as viable competition with defined contribution plans,” says Stewart Lawrence, national retirement practice leader at the Segal Co., an HR consultancy. Adds Deloitte retirement plan consultant Martha Priddy Patterson, “An employer might consider it if it’s paternalistic [or] if it’s in a niche that could use it as a draw for experienced people”—in engineering and manufacturing, for instance.

Top 10 Candidates

While cash-balance plans have characteristics that should appeal to all types of employers, they might be especially well suited for organizations that fall into the following categories:

1. Highly profitable companies of all types and sizes.

- Usually indicated by the owner's desire for a larger tax deduction
- Principals paid more than \$250,000 per year

2. Family businesses.

- The plan can be used as a component of succession planning.

3. Closely held businesses.

- Several owners want a greatly enhanced retirement plan.

4. Law firms of all sizes.

- Tax deferral and asset protection are often very important to this profession.

5. Medical groups of all sizes.

- Tax deferral and asset protection are often very important to this profession.

6. Professional firms of all types.

- CPAs, engineers, architects, etc.

7. Older owners who have delayed saving for retirement.

- They need to squeeze 20 years of saving into 10.

8. Those who highly value asset protection.

- ERISA protects all qualified plan assets from creditors in the event of a bankruptcy or lawsuit.

9. Those who want an enhanced benefits package for executives.

- They want to attract and retain high-caliber employees.

10. Sole proprietors with income exceeding \$250,000 per year.

- All entity types apply.

Source: Lou Kravitz & Associates

Carolyn Hirschman is a business writer based in Rockville, Md. She has written for a variety of business publications including HR Magazine, and has covered workplace issues since 1991.

Copyright 2007 Society for Human Resource Management. Reprinted and/or posted with permission.