

U.S. TREASURY PROPOSES CASH BALANCE LEGISLATION

The Treasury Department released a legislative proposal Monday, as part of the Bush Administration's Fiscal Year 2005 Revenue Proposals, that would affect cash balance plans. The proposal would provide restrictions on the transition provisions in future conversions to cash balance plans. It also would clarify that the basic cash balance design is not age discriminatory and would modify the interest crediting rates included in IRS Notice 96-8 that a plan may use without causing a lump sum "whipsaw" effect. Analogous rules would be developed for other hybrid defined benefit plans such as pension equity plans. The proposal includes a description of the current law and reasons for the change, but does not include statutory language.

The new rules would apply only after the effective date of any legislation that Congress enacts, with no inference to be drawn about the status of prior cash balance plan accruals or conversions.

Future Direction. Early indications are that the Administration will *not* aggressively pursue this legislation. Given the highly politicized nature of this issue, absent a groundswell of pressure from key constituents, we think it unlikely that Congress will take up legislation of this nature during an election year. In the meantime, we understand that the Treasury has no intention of reopening the determination letter program for converted plans until legislation is passed.

Even if this or similar legislation should become law, an important lingering question is what the effect would be on prior conversions and on age discrimination and whipsaw claims against plans with respect to prior years. The material accompanying the proposal does provide some comfort to current cash balance plan sponsors since it is clear that the Administration believes that cash balance plans and conversions to cash balance plans are not inherently age discriminatory. However, according to the proposal, a law change is needed because current law does not provide adequate protection for older workers in every conversion.

Conversions. Except as indicated below, the proposal would require that when a traditional defined benefit plan is converted to a cash balance plan, all current participants would have to continue to receive benefit accruals for five years after the conversion that are at least as valuable as the benefits they would have earned had the prior plan formula been continued. We understand that only benefits under the defined benefit plan could be counted toward meeting this requirement. In addition to this five-year maintenance provision, there could be no "wear-away" of either normal or early retirement benefits, either before or after the five-year transition period. In other words, the cash balance benefit would have to be in addition to benefits accrued under the traditional formula. Thus it would be difficult to provide opening balances without also providing a minimum equal to the accrued benefit under the prior formula plus a cash balance benefit with no opening balance.

Under the proposal, the only penalty for noncompliance with these conversion rules would be an excise tax payable by the plan sponsor equal to the full difference between the benefits required under the proposal and those actually provided to participants. The excise tax otherwise payable, however, would not exceed the greater of the plan's "surplus assets" at the time of conversion and the employer's taxable income. No definition of surplus assets is provided and it is not clear that taxable income for this purpose is the amount in the year of conversion or in some other year or years. It also is not clear whether the excise tax would be payable in the year of the conversion, based on the estimated differences between the prior and new plan benefits, or in future years as the actual differences arise. Noncompliance would *not* result in tax disqualification of the plan.

The proposal indicates that the excise tax would not apply with respect to participants who are offered the choice to remain under the traditional benefit formula or who are provided benefits equal to the greater of the prior and new benefit formulas. Thus, if a plan offers choice to all participants on the conversion date, the proposal would not require that employees electing the cash balance benefits be subject to the five-year maintenance and anti-wear-away provisions.

Age Discrimination. The proposal would clarify existing law by providing that a cash balance plan that grants benefit credits that do not decrease on account of age would satisfy the age discrimination provisions of the Internal Revenue Code, ERISA and ADEA. It also would clarify that certain transition strategies (e.g., including early retirement subsidies in opening balances) would not violate the age discrimination or other qualification rules.

Lump Sums and Whipsaw. The proposal would modify the "whipsaw" rules. Whipsaw is an interpretation of current law, set out in IRS Notice 96-8, that requires the payment of lump sums in excess of account balances when the plan's interest crediting rate exceeds certain benchmarks. Under the proposal, a cash balance plan could distribute an employee's account balance as a single sum, and thereby avoid the whipsaw effect, as long as the plan did not credit interest at an above-market level. The Treasury expects that this new rule would allow plans to credit higher rates of interest than currently.

Effective Date and Conforming Amendments. The proposal indicates that all of its provisions would be effective prospectively. We believe this means the new conversion rules would not apply to prior conversions. The legislative history would indicate that no inference should be drawn as to the status of cash balance plans or cash balance conversions under current law.

Changes would have to be made to the Internal Revenue Code to incorporate any resulting new statutory provisions. Also, conforming amendments to ERISA and ADEA would be necessary.

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