

April 2003

## IRS Gives Cash Balance Plans Half a Loaf

The IRS's recent withdrawal of part, but not all, of its controversial cash balance plan regulations illustrates the old saying that half a loaf is better than none. This Management Alert describes the difficult position that continues for cash balance plans.

### **The IRS Action**

The proposed regulations, which were issued on December 11, 2002, dealt with two separate types of discrimination:

- ♦ in favor of highly compensated employees, and
- ♦ against older employees, *i.e.*, age discrimination.

The IRS withdrew only the portion of the regulations dealing with discrimination in favor of highly compensated employees (HCEs). It did not withdraw the equally controversial age discrimination regulations. In fact, although there have been persistent rumors that the age discrimination regulations would be withdrawn as well, a two-day public hearing on the age discrimination rules was held on April 9 and 10, 2003.

### **Background Refresher**

Cash balance plans (including the related "pension equity plans") are a form of defined benefit pension plan in which the employee's pension is stated in the form of its lump sum cash value rather than in the traditional form of a monthly annuity. They more closely resemble an individual account plan than the traditional pension plan, and are considered more attractive to younger and more mobile employees.

### **A Welcome Sign**

A cash balance plan is usually created by converting an existing, traditional pension plan. Employers often take steps to protect older and long-service employees in the conversion process, either by giving employees a choice between traditional and cash balance benefits or by "grandfathering" certain employees. The withdrawn IRS regulations had cast doubt on whether a plan that included such provisions would be considered to discriminate in favor of HCEs, who are also typically the older employees who benefit from the "grandfather" provisions. The fact that the IRS withdrew this portion of the regulations is a welcome sign that it recognizes that prohibiting employers from protecting older employees in the conversion's plan design will only hurt employees.

### **Continued Uncertainty**

The fact that the IRS did not withdraw the age discrimination portion of the proposed regulations probably indicates that it is not willing to go back to the drawing board with the age discrimination regulations, although the age discrimination regulations have also been widely criticized. In particular, the remaining regulations would provide that certain types of cash balance plans may discriminate against older employees if the rate of growth of their benefit *when converted to an annuity* decreases as they approach normal retirement age. That is a normal feature of many common cash balance formulas, resulting from the normal application of actuarial conversion factors. Pension equity plans, in which the amount cred-

ited each year to the employee's account is expressed as a percentage of final average compensation rather than a dollar amount, are particularly vulnerable to this approach.

The withdrawal of the HCE discrimination portion of the proposed regulations is a hopeful sign that the IRS recognizes that cash balance plans are here to stay and is willing to accommodate common plan design practices that have evolved in the marketplace. It is to be hoped that the IRS, following the April 9 and 10 public hearings, will be equally realistic in revising the age discrimination portion of the regulations or that legislation may provide relief. In the meantime, employers who are contemplating converting their pension plans to a cash balance formula have been left without much needed guidance, and face the risk that their plans may not be approved by the IRS or may be challenged in court by older employees.

*If you have any questions about cash balance and pension equity plans, please contact the Seyfarth Shaw employee benefits group attorney with whom you work or any employee benefits group attorney listed on the website at [www.seyfarth.com](http://www.seyfarth.com).*

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