

Fact Sheet



U.S. Department of Labor
Employee Benefits Security Administration
(formerly the Pension and Welfare Benefits Administration)
May 2003

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 the Employee Retirement Income Security Act or the Internal Revenue Code.



1. 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. For more information on defined benefit plans and defined contribution plans, you may want to review the publication *What You Should Know About Your Pension Rights*. (See page 8 to order this publication.)

2. 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 1-year U.S. 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 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.

Traditional defined benefit pension plans do not offer this feature as frequently. Additional information on vesting and distribution of benefits is in the publication *What You Should Know About Your Pension Rights*.

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. For information on pension rollovers, you may want to order a copy of IRS Publication 575, *Pension and Annuity Income: Rollovers* or Publication 590, *Individual Retirement Arrangements (IRAs): Traditional IRAs - Can I Move Retirement Plan Assets?*. To order, call the IRS toll-free number: 1-800-829-3676.

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 (PBGC). For more information about this protection, see *Your Guaranteed Pension*, a publication of the PBGC, at www.pbgc.gov, or call toll free 1-800-400-7242 to request a copy.

3. 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.

4. 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. For an explanation of defined benefit and defined contribution plans, refer to *What You Should Know About Your Pension Rights*.

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 and rewards 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 many 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. Read *Your Guaranteed Pension* for more information on this protection or contact the PBGC.

5. Is there a Federal pension law that governs cash balance 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 and health benefit plans.

The U.S. 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 U. S. 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.

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.

6. 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, including amendments that convert a traditional pension plan formula to a cash balance plan formula. For example, a plan amendment cannot reduce benefits that participants have already earned. 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.

7. Can my benefits earned under the plan be reduced when the plan benefit formula is converted to a cash balance plan formula?

No. While employers may amend their plans to 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 3 years of compensation, and that the plan is amended to convert its benefit formula to a cash balance plan 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 3 years of compensation when the plan amendment is effective. This benefit (including related early retirement benefits) is protected by law and cannot be reduced.

8. 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 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.

9. Is it possible that I will not accrue any additional benefits under the cash balance plan formula?

In some cases, when your traditional plan formula is changed to a cash balance plan formula, the benefit earned under the old formula may exceed the amount determined to be your benefit under the cash balance plan formula. In this situation, you might not earn any additional benefits until your benefit under the cash balance plan formula exceeds the benefit you had earned under the old formula. This is commonly referred to as “wear away.” There are legal requirements that have to be satisfied with respect to benefit accruals, including prohibition against age discrimination. “Wear away” is one of the issues being closely studied by the EEOC, IRS, and the U.S. Department of Labor.

10. 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:

- ! The accrued benefit under the formula in effect before the amendment;
- ! Any additional benefits (see response to question 9 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.

For more about vesting and distribution of benefits, see *What You Should Know About Your Pension Rights*.

11. Is my employer required to give me a choice of remaining under the old formula rather than automatically switching me to the new 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) Allowing employees to remain under the old formula, while restricting new hires to the new formula;
- b) 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; and

- c) Providing no choice, replacing the old formula and applying the new formula to all participants.

The law permits employers to have such flexibility, but whatever option applies has to satisfy legal requirements. For example, the option may not violate prohibitions against discrimination on the basis of age.

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.

12. If my employer gives me a choice of staying with the old formula or converting to the new cash balance plan formula, how do I make the right choice?

The right choice for you and your family may be affected by a wide range of factors. For example, in making this choice you should take into account your retirement expectations, when you intend to begin receiving your benefits, and the chance that your needs might change.

In analyzing any choice presented under your plan, you will want to compare all the terms and options available to you under the cash balance package with those currently available to you. It is important for you to consider each option under each plan formula.

You will also want to consider the specifics of your retirement benefit, such as how your accrued benefit (including the value of any early retirement subsidy) is defined under each formula, the current value of your accrued benefit under each formula, and its value as an annuity at normal retirement age or as a lump sum distribution.

You may also want to take into account how your choice will affect survivor benefits.

You should also compare the value of other related benefits that may be offered under either choice. For instance, some traditional pension plans provide for an offset or subsidy if you retire prior to the age at which your Social Security benefits commence, or offer credit for service also covered by a disability benefit plan.

In making your decision, you should pay attention to any time limits that may apply and any waivers you may be requested to sign. Finally, you need to consider how long you have been with your employer and whether or not you expect to stay employed with your current employer or change jobs in the future.

You may want to consult a professional advisor for assistance in making your choice.

13. 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 required to give at least 15 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. For more on how to obtain information from your plan, review *What You Should Know About Your Pension Rights*.

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.

For further information about the waiver of ADEA rights, you may call the Equal Employment Opportunity Commission's toll-free number at 1-800-669-4000 (TDD 1-800-699-6820) or visit www.eeoc.gov.

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

Generally, pension plans and health plans are operated independently and are administered separately. If you have questions about your health benefits you should contact your health plan administrator. Be aware that, like pension plans, many health plans can be amended or terminated.

For more information, read *Can Your Retiree Health Benefits be Cut?* (see page 8 to order a copy).

15. 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 the Department of Labor's Employee Benefits Security Administration to speak to a benefit advisors in the EBSA office nearest you. You can reach them by calling toll free at 1-866-444-EBSA (3272) or electronically at www.askebsa.dol.gov.

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).

There are strict time limits for filing such a charge. For more information on Federal laws prohibiting employment discrimination contact the EEOC at 1-800-669-4000 (TDD 1-800-669-6820) or visit www.eeoc.gov.

To obtain copies of *What You Should Know About Your Pension Rights* and *Can Your Retiree Health Benefits Be Cut?*, call EBSA's toll-free request line at 1-866-444-EBSA (3272) or view these publications and others at www.dol.gov/ebsa.

To order *Your Guaranteed Pension* and to obtain more information about federally insured benefits, write or call:

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Washington, DC 20005-4026
Tel 202-326-4000
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This fact sheet has been developed by the U.S. Department of Labor, Employee Benefits Security Administration, Washington, DC 20210. It will be made available in alternate formats upon request: Voice phone: (202) 693-8664; TTY: 1-202-501-3911. In addition, the information in this fact sheet constitutes a small entity compliance guide for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996.

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