OVERVIEW OF CASH BALANCE RETIREMENT PLANS

A cash balance plan is a defined benefit plan, but is a hybrid plan that exhibits features of both defined benefit and defined contribution plans. The most recognizable feature of the cash balance plan is its use of a separate account for each participant. A cash balance account is established for each employee upon becoming a member of the plan.

As noted above, by legal definition, a cash balance plan is a defined benefit plan. Defined benefit plans are subject to a number of statutory requirements that do not apply to defined contributions plans. A cash balance plan must comply with these requirements because it is a defined benefit plan under the law. Most of these requirements were written between 1974 and 1984, before cash balance plans were developed and began to be widely adopted. At that time, most pension plans were based on a formula that expressed an employee's accrued benefit, not as an account balance, but as an annuity commencing at a normal retirement age. The rules for defined benefit plans simply were not developed to address the features of a cash balance plan.

Since the defined benefit pension law does not adequately address cash balance plan issues, the IRS issued IRS Notice 96-8 which contains proposed guidance as to how some provisions applicable to defined benefit plans in general are to be applied in the context of a cash balance plan. In IRS Notice 96-8, the IRS has described cash balance plans as follows:

> In general terms, a cash balance plan is a defined benefit pension plan that defines benefits for each employee by reference to the amount of the employee's hypothetical account balance. An employee's hypothetical account balance is credited with hypothetical allocations and hypothetical earnings determined under a formula selected by the employer and set forth in the plan. These hypothetical allocations and hypothetical earnings are designed to mimic the allocations of actual contributions and actual earnings to an employee's account that would occur under a defined contribution plan. Cash balance plans often specify that hypothetical earnings (commonly referred to as interest credits) are determined using an interest rate or rate of return under a variable outside index (e.g., the annual yield on a one year treasury security). Most cash balance plans are also designed to permit, after termination of employment, a distribution of an employee's entire accrued benefit in the form of a single sum distribution equal to the employee's hypothetical account balance as of the date of distribution. Many cash balance plans also provide that if distribution is in the form of an annuity, the amount of the annuity is determined by dividing the hypothetical account balance by an annuity conversion factor.

The principal advantage of a cash balance plan is that it allows a "highly compensated employee" to contribute significant dollars to a retirement plan at a relatively small cost in terms of contributions for other employees. The cash balance plan typically only covers the highly compensated employee and the lowest paid group (generally consisting of the lesser of 40% of the total number of the employees for the plan year or 50 employees). This use of the lower paid group together with the fact that the lower paid group may have a significant turnover allows most (if not all) of the contributions to the cash balance plan to inure to the benefit of the highly compensated employee.

The typical demographic for a cash balance plan involves a profitable company where the highly compensated employees are age 45 or older and have younger, lower paid employees.

Another advantage of the cash balance plan is its relative flexibility. Under a traditional defined benefit plan, the employer has a mandatory obligation to make a pension plan contribution each year. However, a cash balance plan may be designed to provide that contributions to the highly compensated employee is ten times a "special bonus" each plan year. Thus, if the company's board of directors declares a special bonus of zero, the contribution to the cash balance plan for the highly compensated employee is zero.