Significant Court Rulings Issued on Cash Balance Plans

In Cooper, et. al. v. The IBM Personal Pension Plan, et. al., an Illinois Federal District Court has ruled that a cash balance plan sponsored by IBM violated the age discrimination prohibitions of ERISA. Although IBM is appealing the decision, many plan sponsors are concerned about the consequences of this ruling. The ruling is contrary to the rulings of other District Courts that have upheld cash balance plans contested by participants. The ruling also did not consider the regulations recenlty proposed by the IRS.

IBM converted its defined benefit pension plan to a cash balance plan in 1999. A large number of employees were given the option of choosing between the new cash balance formula or the old pension credit formula. IBM's cash balance plan formula was similar to formulas adopted by many plan sponsors and credited a participant's hypothetical account with pay credits equal to 5% of a participant's compensation and interest credits. The participants in this case alleged that the method by which interest credits accrued on a hypothetical account was discriminatory. The court determined that the interest credits would always be more valuable for a younger employee than an older employee and that an age 65 annuity benefit earned by a younger employee for a year of service would exceed the benefit earned by an older employee for the same service. The court found that the rate of benefit accrual would diminish as the participant came closer to age 65.

The court also found that IBM's previous pension equity plan design, adopted before the cash balance plan, violated ERISA. Under the pension equity plan, participants earned base points determined by age, as well as excess points if the participant's five year average earnings were above the social security compensation limit. The plan imposed a cap at 425 base points and 75 excess points. At retirement, a participant's monthly benefit was determined using a five step formula, including a benefit conversion factor. The court did not accept IBM's assertion that no participant had actually experienced a reduction in accrued benefit under this formula, and instead found that older employees received a lower rate of benefit accrual and had a smaller accrued benefit at age 65 than younger employees. The court held that the benefit conversion formula violated ERISA because employees of different ages working the same number of years and earning the same compensation accrued different retirement benefits. Surprisingly, the court also found that the 425 point cap was impermissible under ERISA despite regulations and numerous rulings permitting benefit caps.

The ruling is difficult to accept since it is based on a simplistic analysis of the technical issues relating to benefit accruals in cash balance plans. The court attacked the fundamental nature of cash balance plans and stated that the plan "looks like a defined contribution plan trying to pass for a defined benefit plan." Since the IRS has proposed regulations governing

cash balance plan formulas as defined benefit plans, this is a surprising conclusion for a court to reach. If the court's decision is ultimately upheld on appeal, it could have a significant impact on cash balance plan participants throughout the country, as plan sponsors may elect to freeze or terminate their cash balance plans, leaving many employees without a defined benefit plan benefit upon retirement.

In another cash balance plan case, Berger v. Xerox Corporation Retirement Income Guarantee Plan, participants alleged that the plan used an impermissible method to calculate lump sum distributions. Unlike the court in the IBM case, this court considered whether the Xerox plan satisifed the technical requirements for cash balance plans set forth in IRS Notice 96-8 and IRS regulations. The court held that these requirements had not been satisfied by the plan. Since Xerox failed to calculate lump sum distributions in a permissible manner, the court ruled that plan violated ERISA.

Since the final adjudication of the IBM case could take a long time, cash balance plan sponsors should not immediately reconsider their plan design in light of this ruling, but should monitor the developments of this case.

IRS Issues Proposed 401(k) Regulations

The IRS has issued new Section 401(k) proposed regulations. The proposed regulations incorporate guidance issued by the IRS over the past few years, clarify and expand on that guidance, and make a few significant changes.

Use of Bottom-up QNECS Limited. The most significant change in the proposed regulations relates to the use of qualified non-elective contributions (QNECs) by plan sponsors to enable a plan to pass the ADP test. To minimize the amount of QNECs required to enable a plan to pass the ADP test, some plans have used a bottom-up QNEC technique that allocates QNECs to the lowest paid plan participants in the greatest amount permitted in order to maximize the ADP of such low paid participants and assist the plan in passing the test. The proposed regulations restrict this practice of targeting QNECs to the lowest paid employees. Under the proposed regulations, the maximum targeted QNEC that can be allocated to a non-highly compensated employee is the greater of 5% or double the "representative contribution rate." A plan's "representative contribution rate" is the lowest contribution rate of any non-highly compensated employee within the group of non-highly compensated employees that consists of half of all eligible non-highly compensated employees under the plan (or the lowest contribution rate of any eligible non-highly compensated employee who is employed on the last day of the plan year). Thus, if targeted QNECs in excess of 5% are allocated to any non-highly compensated employee, then a minimum QNEC equal to half of the greatest QNEC must be allocated to at least half of all non-highly compensated employees who are eligible to participate.

Pre-funding Prohibited. Under the proposed regulations, employers would be prohibited from prefunding contributions in order to accelerate the employer tax deduction asssociated with employer contributions.

Aggregation of ESOPs no Longer Mandated. The mandatory disaggregation of the ESOP and non-ESOP components of a 401(k) plan for ADP and ACP testing purposes has been eliminated. Plan sponsors now have the option of aggregating a plan's ESOP and non-ESOP components for ADP and ACP testing. However, for purposes of the minimum coverage requirements, the ESOP portion of a plan continues to be mandatorily disaggregated from the non-ESOP portion of a plan. Thus, the group of eligible employees under the ESOP and the non-ESOP components of a plan must still separately satisfy ERISA’s minimum coverage requirements, even though they may satisfy the ADP and ACP tests as a group.

Character of 401(k) Assets Protected in a Transfer. If there is a plan to plan transfer of a 401(k) account, the transferor plan must verify that the accepting plan will continue to apply the distribution restrictions to the transferred 401(k) account. This will help assure that contributions will maintain their 401(k) attributes after a transfer.

A**dditional Means of Calculating Gap Period Income Provided**. Additional methods have been provided for calculating income on excess contributions during the period from the end of the plan year to the date on which an excess contribution is distributed.

Multiple Plan Participation Issues Resolved. Under the current regulations, if a highly compensated employee is eligible to participate in more than one 401(k) plan of an employer, or other employers within the same controlled group, the actual deferral ratio (ADR) of that highly compensated employee is calculated by treating all 401(k) plans in which the employee is eligible to participate as one plan. A distorted ADR can result if two plans have different plan years, since more than 12 months of contributions may be taken into account. The proposed regulations solve this problem by providing that the ADR for each highly compensated employee participating in more than one 401(k) plan is determined by aggregating that employee’s elective contributions made within the plan year of the plan being tested. Consequently, testing of each plan in which a highly compensated employee participates will use 12 months of contributions and 12 months of compensation in determining such employee's ADR.

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