

Chapter 11

Cash Balance Plans

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TAX EXEMPT AND GOVERNMENT ENTITIES

Objectives This chapter will give a little history of cash balance plans and then discuss the nuances of such plans. Plan language will be discussed, samples of which can be found at the end of the chapter. At the time of this writing, applications for determinations with regard to defined benefit plans that have converted to cash balance plans (“cash balance conversions”) are still suspended.

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Overview

Cash Balance Plans - History

- ❖ Bank of America adopted one of the first cash balance pension plans in 1985.
- ❖ On September 3, 1993, the U.S. Department of the Treasury issued final 401(a) (4) regulations (Income Tax Regulations 1.401(a) (4)). Section 1.401(a) (4)-8(c) of those regulations created a “Safe-Harbor” for cash balance plans.
- ❖ On January 18, 1996, Notice 96-8 was published providing for “Safe-Harbor” interest rates for cash balance plans.
- ❖ On December 11, 2002, Proposed Regulations were issued providing for “Fresh-Start Rules” for Cash Balance “Conversion Plans”. (These have been withdrawn- see Announcement 2004-57).
- ❖ In 2003, several major cash balance plans were in litigation or seeking declaratory judgments over such issues as rate of accrual and whipsaw issues and age discrimination, including Bank of Boston, Xerox, IBM, and CBS.
- ❖ On February 2, 2004, the U.S. Department of the Treasury issued proposed legislation for cash balance plans

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Overview, Continued

History

Nearly one third of Fortune 100 companies have adopted some form of cash balance plan.

2002 survey of firms with pension plans containing more than 1,000 participants revealed that 19% of plans were cash balance plans.

According to the DOL's Bureau of Labor Statistics publication "Employee Benefits in Private Industry, 2003, published on September 17, 2003:

- 49% of all workers are participating in a Retirement Plan;
- 20% of all workers are participating in a DB Pension Plan;
- 40% of all workers are participating in a DC Plan.
- Some employers maintain both

Of employers with 100+ workers, 33% sponsor a DB Plan.

In DOL's publication: "Employer costs for Employee Compensation—December 2003" published February 26, 2004, retirement and savings averaged 3.1% of compensation of each hour worked by all employees.

According to economists at the Federal Reserve Board, cash balance pension plans account for 25% of all participants in defined benefit plans, and 40% of all assets invested in defined benefit plans.

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Overview, Continued

Types of Plans: The two major types of plans are:

- ❖ Defined Contribution Plans (DC Plans)
- ❖ Defined Benefit Plans (DB Plans).

In DC Plans:

- Separate accounts are created for each participant.
- Participants assume the risk of gains and losses.
- Participants' account balances are distributed upon attaining normal retirement age or separation from service, depending on the terms of the plan document.

In DB Plans:

- Participants' benefit are determined as of their normal retirement age however, the accrual rules of IRC 411(b) require that benefits be accrued over the working life of the participant.
 - The employer assumes any risk of loss to the trust fund
 - The benefits are covered by the PBGC.
 - The plan has funding requirements under IRC 412.
-

Where do cash balance plans fit in?

Cash balance pension plans are considered hybrid plans since they use a combination of attributes from both types:

- Separate “hypothetical accounts” are created for each participant
 - Separate “hypothetical allocations” or “pay credits” are made for each participant.
 - Interest Credits are provided to the hypothetical accounts
 - Participants' “hypothetical accounts” are converted into accruals by projecting the allocation at a stated interest rate from attained age to NRA
 - The employer assumes any risk of loss to the trust fund
 - The benefits are covered by the PBGC.
 - The plan has funding requirements under IRC 412.
 - The plan must satisfy the accrual rules under IRC 411(b)
-

Generic Cash Balance Plans

**Benefit
Accruals under
a Cash Balance
Plan**

A cash balance pension plan is a defined benefit pension plan. Cash balance plans are career average plans in which benefits are accrued incrementally year by year.

The benefit is defined by a formula containing a specified pay credit (or allocation) which is placed into a hypothetical account for each participant. A cash balance plan mimics a money purchase pension plan formula; the employer contributes to each participant a percentage of their plan year compensation (as opposed to average annual compensation).

This allocation is called a “Hypothetical Allocation”. To determine a participant’s accrued benefit at any particular time, the hypothetical account balance is projected, with interest, to normal retirement age. This projected lump sum amount is then converted to an annuity by dividing the amount by the an annuity purchase rate specified under the plan.

The Hypothetical Allocation Formula must satisfy one of the three accrual rules under section 411(b) of the Code. Generally, as a career average plan, the only rule that a cash balance plan can satisfy is the 133 1/3% rule of section 411(b)(1)(B). However, in rare cases, the fractional rule may be able to be satisfied.

Note that a cash balance pension plan is a defined benefit pension plan for all purposes - IRC 415(b), IRC 412, IRC 416, IRC 417(e)(3), etc., except that the accrual formula mimics a money purchase pension plan.

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Generic Cash Balance Plans, Continued

**Portability
under a Cash
Balance Plan**

Generally, a cash balance plan will determine each participant's hypothetical account every year.

Cash Balance plans are usually set up to pay lump sum benefits equal to the hypothetical account balance at any point in time. However, in some cases, the participant may be entitled to a higher benefit if, after projecting the Hypothetical account balance to Normal Retirement Age and discounting to current age by use of the IRC 417(e)(3) assumptions that single sum (present value) amount using the 417(e)(3) assumptions is larger than the hypothetical account balance. This is known as the "whipsaw" effect.

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Generic Cash Balance Plans, Continued

**Definitely
Determinable**

A cash balance plan cannot have any employer discretion in the actuarial assumptions used to determine participants' benefits. The interest crediting mechanism must work independently of employer discretion. Although the employer can change this interest rate mechanism, the change must not reduce benefits accrued as of the date of the change.

In order for a cash balance pension plan to have a definitely determinable benefit formula, two items must be clearly stated:

- First, the Hypothetical Allocation Formula must be clearly stated in the plan and applied in a uniform manner to each participant for each year;
- Second, the interest rate used to project the Hypothetical Allocation must be the same interest rate and must be applied in a uniform manner to all participants who received a hypothetical allocation in that plan year.

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Generic Cash Balance Plans, Continued

Interest Rate under a Cash Balance Plan

The participant's right to both their accrued benefit derived from their hypothetical account balance is IRC 411(d)(6) protected. Thus the interest rate used in projecting the hypothetical account balance is 411(d)(6) protected as well.

Under IRC 411(a)(5) and IRC 411(b), once a participant accrues 1,000 hours of service for the year, they are entitled, under IRC 411(d)(6), to both their Hypothetical Allocation and the Interest Rate (or interest credit). This is in contrast to a defined contribution plan which can have a last day requirement.

Interest credits given under a cash balance plan are not related to the actual investment yield of the plan's assets. The employer assumes the risk of any trust fund earnings shortfall or losses that are in excess of the actuarially determined amount required to fund the plan.

The plan can provide either a stated interest rate or a variable interest rate. The variable interest rate must be locked in on a given date in the plan year and the same interest rate, based upon the variable, must be applied to all participants' Hypothetical Account Balances in a uniform manner.

Hypothetical Allocation Accounts and Interest Adjustments

The current value of a participant's Hypothetical Account, e.g. the Hypothetical Account Balance, for each participant, is determined as of each plan year. The current value of each Participant's Hypothetical Account Balance must equal the sum of all Hypothetical Allocations and their respective interest adjustments.

Example—determining the accrued benefit under a cash balance plan

Example-hypothetical account balances

Assume the following facts:

- ❖ The Hypothetical Allocation formula =10% of IRC 415(c) compensation;
 - ❖ The stated interest rate in the plan = 6% (used for all years);
 - ❖ The plan's normal retirement age is 65.
 - ❖ Participant H is 35 year old and has worked over 1,000 hours in the current and prior plan years. H commenced participation upon attaining age 30. H earned \$30,000 each year.
-

Calculation of current account balance-first year

The account balance for the participant at age 35 is \$20,926. Each year, the account is credited for the allocation amount at 10% of 415(c) compensation. The account is also credited with 6% interest on the account balance. Thus, assuming that hypothetical allocations are made at the end of the year, the hypothetical account balance is \$3,000 at the end of H's first year of service. Note that this calculation is done each year.

Calculating the account balance-end of second year

Assuming no change in compensation, the hypothetical account balance at the end of the second year is the sum of the following:

- \$3,000 (allocation for the first year)
- \$3,000 (allocation for year 1) x 6% interest or \$180
- 10% x \$30,000 compensation or \$3,000.

Thus, the total is \$6,180.

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Example—determining the accrued benefit under a cash balance plan, Continued

Calculating the account balance-end of third year

Assuming no change in the compensation, the third year is the sum of:

- \$6,180
- \$6,180 x 6% earnings, or \$371
- 10% x \$30,000 or \$3,000.

Thus, the total at the end of the third year is \$9,551.

Example—determining the accrued benefit under a cash balance plan, Continued

Determining the accrued benefit

Assume H's hypothetical account balance as of the current year is \$20,926. H's accrued benefit in the form of annuity at Normal Retirement Age at age 35 would be as follows:

- \$20,925.96 projected at 6% from age 35 to NRA
- $\$20,925.96 \times (1.06)^{30}$ (compounding interest for 30 years) = \$120,188.07.

Assuming the plan is using a monthly Annuity Purchase Rate (APR) of 158 from one of the standard Mortality Tables (see 1.401(a)(4)-12 for a partial list of Standard Mortality Tables), H's monthly annuity benefit, upon attaining normal retirement age, would be \$760.68 per month at normal retirement age.

Single sum distributions

Overview-determining the amount of the distribution

Cash balance pension plans are designed to provide for single sum benefits upon separation from service based upon the participant's Hypothetical Account Balance.

Optional forms of benefits subject to IRC 417(e)(3), (e.g. non-life annuity forms and decreasing annuities) must be actuarially adjusted and discounted from normal retirement age to attained age using the assumptions required by IRC 417(e)(3):

- The Applicable Interest Rate (a 30 year U.S. Treasury Rate based upon an annual rate), determined as of the plan's stated Lookback Month and applied to distributions which occur during the plan's stated Stability Period.
-

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Single sum distributions, Continued

**Overview-
determining the
amount of the
distribution**
(continued)

- The mortality table used must be the “Applicable Mortality Table” as defined by Revenue Ruling 95-6 for annuity starting dates commencing 1-1-1995 to 12-30-2002.

The Applicable Mortality Table for annuity starting dates commencing on 12-31-2002 and later, is the table defined by Revenue Ruling 2001-62, (the 94’ GAR table projected to 2002, using 50% unloaded male and 50% unloaded female rates).

**Overview-
determining the
amount of the
distribution**
(continued)

If the cash balance plan provides for single sum distributions on separation from service, IRC 417(e)(3) requires that the single sum be distributed as they usually do– the greater of

- the single sum under the plan terms (usually the Participant’s current Hypothetical Account Balance) or
 - the present value of the participant’s accrued benefit determined using mandated assumptions under section 417(e)(3).
-

**Example
determining
amount of the
distribution
facts**

An example of single sum distributions on separation from service is as follows (using information from prior example):

- H’s Hypothetical Account Balance at age 35 is \$20,926
 - H’s accrued benefit at NRA is a monthly annuity benefit of \$760.68 (or \$9,128.16 a year).
-

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Single sum distributions, Continued

Step 1-convert annuity to single sum

The first step is to convert the participant's \$9,128.16 yearly annuity into a Single Sum benefit at NRA, multiply the annuity by the Annuity purchase rate:

$$\$9,128.16 * 13.17 = \$120,217.87. \quad (13.17 = 158/12)$$

Step 2, discount the single sum amount at age 65 to participant's attained age

The next step is to discount this amount from age 65 to the participant's attained age of 35:

Assume a "Lookback Month" of January 2002 is used, and a Stability Period of a plan year running from March 1, 2002 to February 28, 2003, is used. The 30-year Treasury Bill Rate on January 2002 was 5.45%. Assume that there is no forfeiture on death):

Using the **GUST assumptions** we have the following:

$$\$120,217.87 \text{ divided by } 1/1.0545 \text{ x/y } 30 = \$24,466.48$$

Using the **plan's assumptions** of 6% and a 71' IAM Table

$$\$120,217.87 \text{ divided by } 1/1.06 \text{ x/y } 30 = \$20,931.15.$$

The greater benefit is \$24,466.48 (using GUST assumptions), versus \$20,931.15, (using the plan's assumptions).

Step III- Compare the lump sum calculation with the hypothetical account balance

Next, compare the result of Step II above and the Hypothetical Account Balance of \$20,926.

The larger amount, in this case \$24,466.48, is what must be distributed if H were to separate service now. This satisfies IRC 417(e)(3).

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Single sum distributions, Continued

Whip saw effect As the above example demonstrated, the single sum benefit calculated using the GUST assumptions in the current year, is larger than the participant's Hypothetical Account Balance.

This is sometimes called the "Whipsaw Effect" where the participant receives a greater benefit due to the difference in assumptions used to project the Hypothetical Allocations, as opposed to the assumptions used to discount the participant's accrued benefit from normal retirement age to the participant's attained age.

“Safe-Harbor Cash Balance Pension Plans”

Introduction

On September 3, 1993, the U.S. Department of the Treasury issued final 401(a)(4) regulations (Income Tax Regulations 1.401(a)(4)). Section 1.401(a)(4)-8(c) of those regulations created a “Safe-Harbor” specifically for Cash Balance Plans. The title of the section is “Nondiscrimination in amount of contributions under a Defined Benefit Plan”.

Benefit Formulas

This “Safe-Harbor” requires, in part, that the plan’s design requirement for the Hypothetical Allocation Formula satisfy either:

- ❖ one of the DC “Safe-Harbors” under 1.401(a)(4)-2(b) as modified by 1.401(a)(4)-8(c)(3)(ii)(B), or
 - ❖ the DC “General Test”, under 1.401(a)(4)-2(c), as modified by 1.401(a)(4)-8(c)(3)(ii)(C).
-

Non-discrimination using Designed based safe harbor

If the Hypothetical Allocation formula is to satisfy 1.401(a)(4)-2(b)(3) (safe harbor for uniform allocation points formula), then the plan must meet the following:

- ❖ Provide for a uniform Hypothetical Allocation Formula.
 - ❖ The Hypothetical Allocation Formula must apply on a uniform basis to all employees for the plan year.
 - ❖ The Hypothetical Allocations must also satisfy 1.401(a)(4)-2(b)(3) taking into account all years. No other allocations can be made under the plan.
 - ❖ All employees for the plan year must receive the same percentage of plan year compensation or the same dollar amount.
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“Safe-Harbor Cash Balance Pension Plans”, Continued

Provisions plan can have and still be considered safe harbor

The plan can also provide for the following without jeopardizing the safe harbor status:

- ❖ IRC 401(l) permitted disparity can be used on a defined contributions basis, under Income Tax Regulations 1.401(l)-2.
- ❖ Use different entry dates;
- ❖ Limit the dollar amount of the allocation;
- ❖ Use a set dollar contribution for each uniform unit of service performed by the employee.

All of these would satisfy the Cash Balance “Safe-Harbor” as either a percentage of plan year compensation or as a dollar amount.

Non-discrimination Satisfied using DC General Test

If the modified General Test is used, under Income Tax Regulations 1.401(a)(4)-2(c) and 1.401(a)(4)-8(c)(3)(iii)(c), the plan’s benefit formula must provide for Hypothetical Allocations for all employees, in the plan, for the plan year, and must satisfy the modified General Test of 1.401(a)(4)-2(c).

- ❖ Equivalent Normal Allocation Rates and Equivalent Most Valuable Allocation Rates, (for subsidized benefits), must be used, to determine employee allocation rates and to establish the rate groups.
 - ❖ The allocation rates are either determined as a percentage of compensation or as a dollar amount.
 - ❖ Imputed Permitted Disparity and Grouping may be used to help the General Test to satisfy 1.401(a)(4)-2(c).
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“Safe-Harbor Cash Balance Pension Plans”, Continued

Uniformity requirements and other plan requirements

Certain uniformity requirements must be met:

- ❖ The plan must use uniform vesting;
- ❖ The plan must use uniform service requirements; and
- ❖ No employee contributions are allowed in the Cash Balance Plan.
- ❖ IRC 415(b) limits apply to the Hypothetical Allocations, not 415(c). See I.T. Regs. 1.401(a) (4)-3(d) (2) (ii) (B).
- ❖ Qualified Disability Benefits can also be taken into account.
- ❖ Equivalent Annual Allocation rates must be determined in a consistent manner for all employees, for the plan year.
- ❖ The same interest rate must apply to all participants and the same options must be available to all participants.

Interest adjustments

The dollar amount of the Hypothetical Allocation, for each employee, for the plan year, is automatically adjusted, using an interest rate listed in 1.401(a)(4)-8(c), that is compounded no less frequently than annually for the period that begins on a date within the plan year.

- ❖ The interest adjustment begins on a date in the plan year and ends at normal retirement age.
- ❖ The interest rate used cannot be contingent on the employees’ satisfaction of any requirement (such as continuation of employment).
- ❖ The interest adjustment must be provided through the later of normal retirement age or separation from service, if the employee works beyond normal retirement age.
- ❖ Under Income Tax Regulations 1.401(a)(4)-8(c)(3)(iv)(B), the interest rate can be a single interest rate, specified in the plan, that is the same interest rate applied to all employees, for all years.

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“Safe-Harbor Cash Balance Pension Plans”, Continued

**Interest
adjustments
(continued)**

- ❖ The interest rate can either be a stated interest rate or a variable interest rate.
 - Under Income Tax Regulations 1.401(a)(4)-8(c) (3) (iv) (C), a Variable Interest Rate can be used if certain requirements are met:
 - The plan must state which variable interest rate index is used and the method for determining the current value of that Variable Interest Rate.
 - The period during which the interest rate is applied cannot exceed one year.
 - The Variable Rate must be determined on a specified date within the plan year (period) or the immediately preceding plan year (period), or an average of the values of the Variable Interest Rate as of 2 or more specified dates during the current plan year or the immediately preceding plan year.

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“Safe-Harbor Cash Balance Pension Plans”, Continued

**Permissible
variable rates**

Permissible Variable Interest Rates are as follows:

- ❖ The rate on a 3 month Treasury Bill;
- ❖ The rate on a 6 month Treasury Bill;
- ❖ The rate on a One Year Treasury Bill;
- ❖ The yield on a One Year Treasury Constant Maturities;
- ❖ The yield on a two year Treasury Constant Maturities;
- ❖ The yield on a five year Treasury Constant Maturities;
- ❖ The yield on a ten year Treasury Constant Maturities;
- ❖ The yield on a thirty year Treasury Constant Maturities.

These rates are published in the Federal Reserve Bulletin. The variable interest rate applies to a Hypothetical Allocation for all future periods.

The value of the variable interest rate can be determined in the current period and one or more periods immediately preceding the current period (not to exceed 5 years in the aggregate).

Use of a Standard Interest Rate and Standard Mortality Table from Income Tax Regulations 1.401(a)(4)-12 is considered to be a reasonable rate.

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“Safe-Harbor Cash Balance Pension Plans”, Continued

**Other
attributes of a
safe harbor
cash balance
plan**

The normal retirement benefit under a “Safe-Harbor” Cash Balance Pension Plan is an annuity commencing at normal retirement age that is the actuarial equivalent of the employee’s Hypothetical Allocations projected by their respective interest rates to normal retirement age.

The plan must use the same uniform normal retirement age for all participants.

All subsidized optional forms of benefits must satisfy the uniform subsidies requirement of I.T.Reg. 1.401(a)(4).

The accrual increase for a plan year under a “Safe-Harbor” Cash-Balance Plan is the actuarial equivalent of the plan year’s Hypothetical Allocation, projected by the plan’s interest rate, from the year allocated (accrued) to normal retirement age.

Any past service credit must be granted on a uniform basis to all current employees. Interest adjustments to the Hypothetical Allocation must continue to be made until the participant separates from service, even if it is after normal retirement age.

“Safe-Harbor” Interest Rates under Notice 96-8

Introduction

On January 18, 1996, the U.S. Department of the Treasury published Notice 96-8. Notice 96-8 provided for use of several “Safe-Harbor” interest rates to project Hypothetical Allocations.

The interest rates published in this Notice closely approximate the IRC 417(e)(3) 30 year U.S. Treasury rate, on an annual basis, such that the Hypothetical Account Balances will be equivalent to single sums calculated using the IRC 417(e)(3) assumptions to discount the participant’s accrued benefit from normal retirement age to the age of distribution. By using these “Safe-Harbor” interest rates, the employer can elect to distribute the Hypothetical Account Balance as the participant’s single sum distribution without having to calculate present values under IRC 417(e)(3).

“Loading” the benefits

Notice 96-8 provides guidance on whether a cash balance plan has a “frontloaded” or “backloaded” interest crediting mechanism.

A “frontloaded” interest credit plan is described as one where future interest credits to an employee’s hypothetical account are not conditioned upon future service. In a frontloaded interest credit plan, the benefits attributable to future interest credits for a hypothetical allocation accrue at the same time that the benefits attributable to the hypothetical allocation accrue. As a result, if an employee terminates employment and defers distribution to a later date, interest credits will continue to be credited to that employee’s hypothetical account in the same manner as interest credits are credited to the hypothetical account of a current employee.

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“Safe-Harbor” Interest Rates under Notice 96-8, Continued

“Loading” the benefits
(continued)

A “backloaded” interest credit plan is described as one where future interest credits to an employee’s hypothetical account are conditioned upon future service. Backloading, under the context of section 411(b), refers to benefit accruals which, the closer a participant gets to NRA, are significantly larger than earlier in one’s career. Where interest credits are tied to continued service with the employer, as noted in Notice 96-8, the plan would probably not satisfy the accrual rules of section 411(b).

Example – “backloaded” plan

The Forrest Greens Co. Plan provides for a pay-based credit of 7% of salary per year to a participant’s account. For as long as the participant is employed with Forrest, the participant’s account will earn the interest credited to 5-year T-Bills as of December 1 of the preceding year. If a participant leaves the employ of Forest prior to attainment of age 65, and elects not take a distribution from the Plan, the account will receive no additional interest credits.

The Forrest plan is a “backloaded” plan – both in terms of the interest crediting mechanism and for benefit accruals. This is because for each year of participation, a participant has only earned the 5-year T-bills rate through that year. Interest credits for any future year are not earned until the participant completes service for such year. The Forrest plan fails the anti-backloading rules of section 411(b)(1).

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“Safe-Harbor” Interest Rates under Notice 96-8, Continued

Example 1

The Hale Co Plan provides that a participant’s hypothetical account balance will receive annual periodic interest adjustments equal to 7% (regardless of continued employment). The accrued benefit is the annuity benefit provided at age 65 by the current hypothetical account balance increased by interest at 7% to age 65. The Plan allows a participant that separates from employment prior to NRA (age 65) to receive the actuarial equivalent of their accrued benefit in the form of a single sum, or, if greater, the current hypothetical account balance. In determining actuarial equivalence, the Plan’s stated pre-retirement assumptions are the “applicable interest rate” and “applicable mortality table” pursuant to 417(e).

Additionally, the Hale Plan provides that for purposes of determining a single-sum distribution, the annuity payable at normal retirement age is projected using 4% as the annual periodic adjustment instead of the 7% that would otherwise be credited.

Margaret, who is fully vested, resigns from Hale. She has a hypothetical account balance equal to \$100,000. She elects to receive a single-sum distribution. At the time of Margaret’s resignation, the applicable 417(e) rate is 6%. The Hale’s actuary determines that the actuarial equivalent, using stated assumptions, of Margaret’s accrued benefit (projected using 7%) is \$110,000.

Since Margaret opted to receive her benefit in the form of a single-sum distribution, the present value of the resulting annuity, determined using the projection rate of 4% and discounting back using the applicable 417(e) rate of 6%, is \$95,000.

Hale distributes \$100,000 to Margaret, not the \$95,000 amount determined projecting forward at 4%. Still, Hale has impermissibly forfeited \$10,000 (\$110,000 less \$100,000) of Margaret’s accrued benefit. The 3% difference in the projection rate has been conditioned upon Margaret choosing an annuity. This is a violation of section 1.411(a)- 4T of the Regulations.

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“Safe-Harbor” Interest Rates under Notice 96-8, Continued

Example 2

The Jasper Dog Co Plan, as amended for RPA ’94, provides that a participant’s hypothetical account balance will receive annual periodic interest adjustments equal to 5% (regardless of continued employment). The accrued benefit is the annuity benefit provided at age 65 by the current hypothetical account balance increased by interest at the 1-year T-Bill rate to age 65. The Plan provides that if a participant separates from employment prior to NRA (age 65), a participant who elects to receive their benefit in the form of a single-sum will receive the actuarial equivalent of their accrued benefit at NR. In determining actuarial equivalence, the Plan’s stated pre-retirement assumptions are the “applicable interest rate” and “applicable mortality table” pursuant to 417(e).

James, who is fully vested, resigns from Jasper. He has a hypothetical account balance equal to \$100,000. He elects to receive a single-sum distribution. At the time of James’ resignation, the 1-year T-Bill rate is 5% and the applicable 417(e) rate is 6%. The Jasper’s actuary determines that the actuarial equivalent, using stated assumptions, of James’ accrued benefit (projected to NRA using 5%) and discounting backwards (from NRA to James’ attained age) is \$90,000.

Jasper distributes \$90,000, not \$100,000, to James. There is no violation under section 417(e) or section 411(a). Of course, Jasper could amend the plan to provide the hypothetical account balance, if greater.

Assuming that the section 417(e) rate always exceeds the plans stated projection rate, the use of the section 417(e) rate when converting the accrued benefit from NRA to an equivalent single sum at termination will always produce an amount less than a participant’s hypothetical account.

Under section 417(e), as amended by RPA ’94, Jasper need not provide for a single sum equal to the greater of the value of the hypothetical account or the actuarial equivalent of the accrued benefit payable at NRA. Section 417(e) merely requires payment of at least the actuarial equivalent of the accrued benefit payable at NRA, using the section 417(e) rates.

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“Safe-Harbor” Interest Rates under Notice 96-8, Continued

**Safe-Harbor
“Interest
Rates”**

The following are the approved “Safe-Harbor” interest rates:

<u>Standard Index:</u>	<u>Associated Margin:</u>
1. Discount Rate on 3-Month Treasury Bills	175 Basis Points
2. Discount Rate on 6-Month and 12-Month Treasury Bills	150 Basis Points
3. Yield on 1-Year Treasury Constant Maturity	100 Basis Points
4. Yield on a 2-Year or 3-Year Treasury Constant Maturity	50 Basis Points
5. Yield on a 5-Year or 7-Year Treasury Constant Maturity	25 Basis Points
6. Yield on 10-Year or longer Treasury Constant Maturity	0 Basis Points
7. Annual Rate of Change of CPI	3 Percentage Points

These rates are listed in the Federal Reserve Bulletin and the CPI Index is published by the U. S. Department of Labor. Since shorter term securities yield a lower interest rate, the basis points represent the difference between the yield of that security and the yield on a 30-year U.S. Treasury Security on an Annual basis.

In developing these standard indices and associated margins the Service and Treasury took into account the historical relationship between each of these indices and the rate of interest on a 30-Year U.S. Treasury security.

An interest rate that is capped at the IRC 417(e)(3) rate, if lower, is an impermissible forfeiture under IRC 411(a).

No interest rate or indices will be added to this list of “Safe-Harbor” interest rates, unless the interest rate index or associated margin includes an analysis of the historical relationship between the index and the rate for a 30-year U.S. Treasury security.

Penalty for no notice

Overview

The excise tax required for failure to give this notice to plan participants , e.g. failure to give notice to any affected participant or alternate beneficiary (in the case of a QDRO), shall be \$100 for each day in the non-compliance period with respect to such failure, for any applicable individual.

The term ‘non-compliance period’ means, with respect to any failure, the period beginning on the date the failure first occurs and ending on the date the notice to which the failure relates is provided or the failure is otherwise corrected.

If the failure to give notice is unintentional, and the person subject to liability exercised reasonable diligence to meet the requirements of this section, the excise tax shall not exceed \$500,000.

No excise tax shall apply to failures that were not discovered or where reasonable due diligence was exercised, and no tax shall apply to failures that were corrected within 30 days.

Section 204(h)(6)(A) of ERISA requires that the participants be given the greater of the prior benefit accrual formula or the amended accrual formula if there is an egregious error of failure to give notice promptly, after it is discovered that notice was not given, or there was a failure to give notice, (and the required information), to most of the participants.

This provision applies to any defined benefit plan or individual account plan which is subject to the funding standards of IRC 412. The effective date of this provision is June 7, 2001.

Cash Balance-Plan requirements

Overview

- ❖ The benefit formula, e.g. the Hypothetical Allocation Formula, must be stated in the plan, and must provide for Hypothetical Allocations and interest adjustments.
 - ❖ The interest rate must be stated.
 - ❖ The plan must provide that an employee's accrued benefit under the plan is the employee's Hypothetical account balance, projected to normal retirement age using the plan's interest rate, and then divided by the plan's annuity purchase rate to determine the participant's annual or monthly annuity as of normal retirement age.
 - ❖ The participant's Hypothetical Account Balance, is the sum of the participant's projected Hypothetical Allocations, increased at the plan's interest rate (interest credit), from the year of allocation to the current year, or date of distribution.
 - ❖ The plan must satisfy the requirements of Income Tax Regulations 1.401(a)(4)-3(b) and (c) and IRC 411, regarding optional forms of benefit, past service credits, post-normal retirement age benefits, and uniformity changes in the plan's benefit formula.
 - ❖ If the plan provides for single sum distributions subject to IRC 417(e)(3), the plan must provide that the greater benefit will be distributed, either the participant's Hypothetical Account Balance, or the present value of the participant's accrued benefit determined using either the GUST assumptions under IRC 417(e) (3), e.g. (the Applicable Interest Rate and Applicable Mortality Table), or the plan's actuarial equivalent's, whichever produces the larger single sum benefit.
 - ❖ A cash balance plan must satisfy at least one of the accrual rules of 411(b)(1), usually the 133 1/3 rule.
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Court Cases

Berger vs. Xerox Corporation Retirement Plan, August 1, 2003, U.S. Circuit Court of Appeals for the 7th Circuit

This case was brought in the Seventh Circuit and appealed to the U.S. Circuit Court of Appeals for the 7th Circuit, the opinion was published on August 1, 2003. In this case the Plaintiffs brought suit for Breach of Fiduciary Duty by the employer for failing to pay the proper Single Sum amount to participants who separated from service prior to normal retirement age.

In this case, the Xerox Cash-Balance Plan projected Hypothetical Allocations from the date allocated to current age using a One Year U.S. Treasury Rate plus 1%, that was applicable to that plan year. However, if a participant separated from service prior to normal retirement age, Xerox would project the Hypothetical Allocations from attained age to normal retirement age, using the PBGC discount rate and not the One Year U.S. Treasury Rate plus 1%. Therefore, the Hypothetical Allocations instead of being projected to normal retirement age from attained age using the 1 Year U.S. Treasury Bill plus 1%, attributable to the year of each Hypothetical Allocation, were instead projected using the PBGC rate. This practice only applied to participants who separated from service prior to attaining normal retirement age. Those who remained until normal retirement age had each Hypothetical Allocation projected to normal retirement age using the applicable one year U.S. Treasury rate plus 1%. Had the Hypothetical Allocations been properly projected to normal retirement age using the 1 year U.S. Treasury Bill rate plus One percent, and then been discounted from normal retirement age to current age, using the PBGC rates, the participants would have received a larger Single Sum distribution. This is primarily true because the One-Year U.S. Treasury Rate plus 1% used to project the Hypothetical Allocations, was a greater interest rate than the PBGC interest rate used to discount benefits from normal retirement age to current age.

Therefore, calculated correctly, the present value of accrued benefit would be the larger benefit, rather than the Hypothetical Account Balance, on the participant's date of distribution. Any limitation on the interest rate used to project Hypothetical Allocations, is a violation of ERISA. In addition, the interest factor or interest credit vests as soon as the participant attains 1,000 hours of service for a plan year. A participant must receive the present value of their accrued benefit determined at normal retirement age, if it is greater than the participant's Hypothetical Account Balance. *May Dept. Stores Co. v. Federal Ins. Co.* 305 F3r. 597, 600 (7th Cir. 2002); *Esden v. Bank of Boston* 229 F. 3rd 154, 164, 183 (2nd Cir. 2000).

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Court Cases, Continued

Berger vs. Xerox Corporation Retirement Plan, August 1, 2003, U.S. Circuit Court of Appeals for the 7th Circuit (continued)

The One Year U.S. Treasury Bill plus 1% fluctuated between 4.4% to 9.7% between 1990 and 2000, whereas the PBGC rate fluctuated between 4% and 6.5%. In *Esden v. Bank of Boston* 229 F.3rd. 168, 169, the Court held, the retirement benefits payable at normal retirement age are determined by reference to the Hypothetical Account Balance projected to normal retirement age, including benefits attributable to interest credits to that age. The Court found that the Xerox plan's method of computing the Plaintiff's lump-sum entitlements violates ERISA. The Court of Appeals Modified and Affirmed the Lower Court's ruling.

Cooper vs. IBM July 31, 2003, Federal District Court for the Southern District of Illinois

In the *Cooper vs. IBM* case, the Federal District Court for the Southern District of Illinois, located in the 7th Circuit, handed down the following ruling on July 31, 2003. The Court held that IBM's cash-balance plan violated age discrimination under ERISA, specifically IRC411(b)(1)(H). In the *IBM* case, IBM in 1995 adopted a hybrid plan that provided pension credits, that increased with age up to a maximum. The Court found that this Hybrid formula violates 204(b)(1)(G) and (H) of ERISA, which states that any benefits that accrue at a rate which is reduced because of age or the attainment of any age is a violation of 204(b)(1)(H) of ERISA. The court also found that the 1995 hybrid formula failed to satisfy any one of the IRC411(b) accrual rules. On July 1, 1999, IBM adopted an amendment converting their plan to a Cash-Balance Pension Plan. The court found that the Cash-Balance formula adopted by IBM violated 204(b)(1)(G) and (H) of ERISA because benefits accrue at a rate that is reduced because of the attainment of any higher age. The Court held that that is in violation of section 204(b)(1)(G) and (H) of ERISA. The Court reviewed accrual increases, under section 204(b)(1)(G) and (H) of ERISA, on a benefits basis. Since two participants with the same compensation, but at different ages will accrue a different benefit, the older participant's benefit at normal retirement age being smaller than the other similarly situated participant, the court held that IBM's Cash Balance Plan violated 204(b)(1)(G) and (H) of ERISA.

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Court Cases, Continued

**Godinez vs.
CBS, 2003, 9th
U. S. Circuit
Court of
Appeals**

The 9th U.S. Circuit Court of Appeals ruled that CBS's conversion Cash Balance Plan did not violate ERISA or the ADEA, 31 EBC 2221 (9th Cir. 2003) (unpublished). The Plan sponsor's decision to change the structure of the plan from a traditional defined benefit plan to a cash balance plan was not a fiduciary act. Second, there was no evidence of a decrease in accruals other than the statement of an expert that a future study would show that participants would have received more under the traditional Defined Benefit Plan. The Court found that there was no evidence of a disproportionate impact on older employees. The plan provided enhanced benefits to participants who were over the age of 41. The Court held that the CBS Cash Balance plan and conversion did not violate ERISA's fiduciary standards, and did not result in an impermissible cutback of benefits and did not violate 204(b)(1)(G) and (H) of ERISA, e.g. age discrimination under ERISA.
