

June 6, 2002

MEMORANDUM FOR MANAGER, EP DETERMINATIONS QUALITY ASSURANCE

FROM: Paul T. Shultz, Director  
Employee Plans, Rulings and Agreements

SUBJECT: Section 401(a)(26) Issue Arising in Cash Balance  
Plan Determination Letter Applications

Questions have been raised about whether certain newly established defined benefit plans with cash balance formulas provide “meaningful benefits” for employees. It has come to our attention that certain cash balance plans provide vastly different benefits for shareholder and non-shareholder employees (e.g., (1) an annual hypothetical allocation of \$45,000 for the shareholder and \$100 for the non-shareholder employees, or (2) an annual hypothetical allocation of \$45,000 for the shareholder and 1 ½ % of compensation for the non-shareholder employees). The issue is whether such plans satisfy section 401(a)(26) of the Code. More specifically, the issue is whether the plans provide meaningful benefits as required under section 1.401(a)(26)-3 of the regulations.

Relevant Law

A qualified defined benefit plan must satisfy section 401(a)(26) of the Internal Revenue Code (Code). To satisfy section 401(a)(26), a plan must benefit at least the lesser of (i) 50 employees of the employer, or (ii) the greater of 40 percent of all employees of the employer, or 2 employees (or if there is only 1 employee, such employee). For these purposes, a plan may exclude from consideration employees described in paragraphs (3) and (4)(A) of section 410(b) of the Code. See Code sections 410(b)(3) and 410(b)(4)(A) and regulation section 1.410(b)-6 for definitions of excludable employees.

Section 1.401(a)(26)-3(a) of the Income Tax Regulations provides that a defined benefit plan that does not meet one of the exceptions in section 1.401(a)(26)-1(b) must satisfy section 1.401(a)(26)-3(c) with respect to its prior benefit structure. A plan’s prior benefit structure satisfies that paragraph if the plan provides “meaningful benefits” to a group of employees that includes the lesser of 50 employees or 40 percent of the employer’s employees. A plan will satisfy this requirement if at least 50 employees or 40 percent of the employer’s employees currently accrue meaningful benefits under the plan, or if at least 50 employees and former employees or 40 percent of the employer’s employees and former employees have meaningful accrued benefits under the plan.

A newly established defined benefit plan that does not meet one of the exceptions in section 1.401(a)(26)-1(b) must satisfy section 1.401(a)(26)-3(c). Section 1.401(a)(26)-3(c)(2) of the regulations provides that whether a plan is providing meaningful benefits, or whether individuals have meaningful accrued benefits under a plan, is determined on the basis of all the facts and circumstances. The relevant factors in making this determination include, but are not limited to, the following:

- the level of current benefit accruals;
- the comparative rate of accruals under the current benefit formula compared to prior rates of accrual under the plan;
- the projected accrued benefits under the current benefit formula compared to accrued benefits as of the close of the immediately preceding plan year;
- the length of time the current benefit formula has been in effect;
- the number of employees with accrued benefits under the plan; and
- the length of time the plan has been in effect.

A plan does not satisfy the meaningful benefit requirement if the facts and circumstances indicate that the plan exists primarily to preserve accrued benefits for a small group of employees and functions more as an individual plan for the small group of employees or for the employer.

Section 1.401(a)(26)-5 of the Income Tax Regulations provides that, generally, an employee is treated as benefiting under a plan for a plan year if and only if, for that plan year, the employee would be treated as benefiting under the provisions of regulations section 1.410(b)-3(a), without regard to section 1.410(b)-3(a)(iv). A former employee is treated as benefiting for a plan year if and only if the former employee would be treated as benefiting under the rules in section 1.410(b)-3(b).

Section 1.401(a)(26)-5(a)(2) of the Income Tax Regulations provides for the determination of whether a plan provides meaningful benefits in the case of a benefit offset arrangement. In this case, however, the requirements under 1.401(a)(26)-5(a)(2)(ii) or (iii) must be satisfied (relating to sequential or concurrent offset arrangements).

#### Application of Relevant Law

If a plan is a newly established defined benefit plan, there are no prior rates of accrual under the plan with which to compare current benefit accruals. Thus, when such a plan applies for a determination letter, whether the plan satisfies the meaningful benefit requirements of section 401(a)(26) of the Code and section 1.401(a)(26)-3(c) of the regulations must be determined by taking the benefits provided under the plan in the first plan year into consideration. For this purpose, the accrued benefits under a cash balance plan should be tested on a benefits basis (by crediting the hypothetical accounts with the hypothetical interest to the participant's normal retirement age, and

converting the resulting hypothetical account balance to an actuarially equivalent annuity benefit commencing at the same age). In the following examples, the effect of the type of formulas about which questions have been raised on the accrual rates of a group of participants is demonstrated. The accrual rates are calculated by dividing the participant's annuity benefit at normal retirement age by the participant's compensation. These examples are similar to actual cases in which this issue has been raised.

<u>PLAN</u>	<u>SHAREHOLDER ALLOCATION</u>	<u>SHAREHOLDER ACCRUAL RATE (% of Comp.)</u>	<u>ALLOCATIONS FOR OTHER ELIGIBLE EMPLOYEES</u>	<u>OTHER EE'S ACCRUAL RATE RANGE (% of Comp.)</u>
X	\$45,000	5.99%	\$100	0.03% - 0.37%
Y	\$45,000	4.55%	1.25% of pay	0.24% - 0.60%

Some cash balance plans that have been submitted contain a provision that offsets the benefit provided under the cash balance plan by the benefit provided under a profit sharing plan maintained by the same employer. Under this kind of arrangement, there may be participants who do not receive any allocation to their hypothetical account balance (especially during the early years of the cash balance plan) because their accrued benefit under the cash balance plan is completely offset by their benefit under the profit sharing plan. It will be necessary to insure that the requirements of sections 1.401(a)(26)-5(a)(2)(ii) or (iii) of the regulations are satisfied prior to applying section 1.401(a)(26)-5(a)(2) to determine whether the cash balance plan provides meaningful benefits. Note that these rules will not be satisfied if the offset applies for some participants (usually non-highly compensated participants) but not all participants.

### Conclusion

The extremely low accrual rates for all of the non-shareholder employees in Plan X and the majority of the non-shareholder employees in Plan Y suggest that Plan X and Plan Y do not provide meaningful benefits for the non-shareholder employees. The wide difference in the accrual rates for the shareholder and the non-shareholders suggest that the plans exist primarily to provide accrued benefits for the shareholder(s) and function more as an individual plan for the shareholder.

In general, where a defined benefit plan that is tested on a benefits basis is found to provide much larger benefit accruals to shareholders (or other principals) and benefit accrual rates of less than one-half of one percent (0.5%) of compensation (per year of participation or service) for non-shareholder employees, the questions of whether the plan provides meaningful benefits and whether the plan exists primarily to benefit shareholders should be raised when reviewing determination letter applications.

The facts and circumstances of each case must be taken into consideration. Determination cases with this issue should be processed in the area offices, taking the facts and circumstances into account to determine whether the plan provides meaningful benefits to at least the lesser of (1) 50 employees, or (2) the greater of 40 percent of all employees or 2 employees (1 employee if there is only 1 employee). (For these purposes, fractional parts of a number of employees are rounded up to the next whole number: e.g., 5.2 employees are rounded to 6 employees.) Technical advice may be requested in accordance with the usual procedures if deemed appropriate.

#### Additional Comments

Although this memorandum focuses on cash balance plans, questions of whether a plan provides meaningful benefits and whether a plan exists primarily to benefit shareholders should also be raised when reviewing determination letter applications for defined benefit plans that do not have cash balance formulas but provide much larger benefit accruals for shareholders (or other principals) and, when tested on a benefits basis, have benefit accrual rates of less than one-half of one percent (0.5%) of compensation (per year of participation or service) for non-shareholder employees.