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Guest Article

Deloitte & Touche

(From the August 4, 2003 issue of [Deloitte & Touche's Washington Bulletin](#), a periodic update of legal and regulatory developments relating to Employee Benefits. Hyperlinks within the article have been added by BenefitsLink.)

IBM's Cash Balance and Pension Equity Formulas Violate ERISA, District Court Rules

A federal district court on July 31 ruled IBM's cash balance and pension equity formulas violate ERISA's age discrimination prohibitions. *Cooper, et al. v. The IBM Personal Pension Plan, et al.*, Civil No. 99-829-GPM (S.D. Ill. July 31, 2003). The district court ruled cash balance formulas are inherently age discriminatory because identical interest credits necessarily buy a smaller age 65 annuity for older workers than for younger workers due to the time value of money. Until now, that controversial position had been limited to cash balance critics and some academics.

Late on Friday, the Seventh Circuit Court of Appeals held Xerox's cash balance plan violated ERISA. *Berger, et al v. Xerox Corp. Retirement Plan*, No. 02-3674 (7th Cir. August 1, 2003). Issues in that case will be addressed next week.

In 2000, a different Seventh Circuit district court reached the opposite conclusion in a case involving Onan Corporation's cash balance plan. That court ruled cash balance plans are not inherently age discriminatory, but did not resolve several other ERISA claims arising out of Onan's cash balance conversion. The parties to that case later settled.

Case Background and Summary

The key issues in *Cooper* are whether IBM's pension equity formula, implemented in 1995, and the cash balance formula that replaced it in 1999, violate ERISA's age discrimination prohibitions. There are two ERISA provisions in play. Section 204(b)(1)(G) provides a defined benefit plan does not satisfy ERISA's benefit accrual requirements "if the participant's accrued benefit is reduced on account of any increase in his age or service." Section 204(b)(1)(H)(i) provides a defined benefit plan does not satisfy these requirements "if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age."

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The 204(b)(1)(G) Claim

[According to the district court](#), IBM's pension equity formula-- the "Pension Credit Formula" or "PCF"-- violates section 204(b)(1)(G) because, under the formula, employees of different ages that work for the same number of years and earn identical salaries will accrue different retirement benefits. The court reached its conclusion by applying the PCF to hypothetical employees beginning work at ages 35 and 50, respectively. Over the course of their 15 year careers, the court found the age 35 employee would accrue an age 65 normal retirement benefit of \$1,259.22 per month, whereas the age 50 employee would accrue an age 65 normal retirement benefit of only \$1,099.10 per month.

The court also cited a hypothetical employee starting work at age 25. Under the PCF, he would stop earning credits between ages 58 and 59 because the plan caps the number of credits an employee can earn. As a result, if he continued working to normal retirement age his accrued benefit would decline because the PCF's benefit conversion factor increases with age.

IBM argued, for purposes of ERISA section 204(b)(1)(G), the court should have focused on the actual experience of the individual plaintiffs instead of hypothetical employees. According to IBM, none of the plaintiffs actually experienced a reduction in their accrued benefits and thus have no legal standing to assert a 204(b)(1)(G) claim. The statutory language (i.e., "... if the participant's accrued benefit is reduced ...") appears to support IBM's position, but the district court disagreed.

The 204(b)(1)(H)(i) Claim

The participants' 204(b)(1)(H)(i) claim with respect to both the PCF and the cash balance formula turns on the meaning of the term "rate of benefit accrual." Neither ERISA nor the IRC (which includes a parallel provision to 204(b)(1)(H)(i)) specifically defines this term.

If "rate of benefit accrual" means the annual change in a participant's immediately payable benefit (or, in the case of the cash balance formula, the annual change in the participant's cash balance account), there is no age discrimination problem under section 204(b)(1)(H)(i). Under both formulas, the rate of benefit accrual measured this way does not decline with age. (Note that the PCF's cap on credits an employee can earn should not be a problem under 204(b)(1)(H)(i) because the statute specifically permits service-based limitations on accruals.)

In the Onan case, the district court concluded the change in a participant's hypothetical cash balance account is a legitimate way to measure the rate of benefit accrual under a cash balance formula. But the district court in this case took a more rigid view, and ruled "rate of benefit accrual" refers "to the rate at which an employee accrues a benefit payable in the form of an annuity that commences at age 65." Under this standard, the court concluded both IBM's PCF and cash balance formula violate ERISA section 204(b)(1)(H)(i).

Effect on Plan Sponsors

IBM already has said it will appeal the district court's decision to the Seventh Circuit Court of Appeals, and the case eventually could find its way to the Supreme Court. As such, the district court's decision represents only the first step in a legal odyssey that could take years to complete.

If the district court's decision survives the appeals process, it could have an adverse impact on all cash balance plans. If the rate of benefit accrual is measured as the change in participants' normal retirement benefits, the only way cash balance plans can pass muster under ERISA section 204(b)(1)(H)(i) is to provide significantly more generous interest credits for older workers than for younger workers. But even that may not work, and it may create other problems

under the anti-backloading rules and the IRC section 401(a)(4) nondiscrimination rules, among other things.

Of course, this battle is not limited to the courts. Last year, the Treasury Department issued proposed regulations that would allow "eligible" cash balance plans to determine the rate of benefit accrual for purposes of IRC section 411(b)(1)(H) (and ERISA section 204(b)(1)(H)(i)) by reference to the annual change in participants' hypothetical cash balance accounts. In order to be an "eligible" cash balance plan, the plan would have to satisfy certain specific requirements. The courts generally defer to "reasonable" regulations, but a protracted court battle over whether deference is due these regulations could ensue if Treasury issues them in final form.

Congress also could get involved by enacting age discrimination and other rules specifically for cash balance and other alternative defined benefit plan designs. But lawmakers so far have been unwilling to do anything on this issue that might be perceived as detrimental to plan participants. At this point, there is no reason to believe that will change.

Deloitte & Touche

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If you have questions or need additional information about this article and you do not have a Deloitte & Touche advisor, please contact Martha Priddy Patterson (202.879.5634) or Robert B. Davis (202.879.3094).

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