IVINS, PHILLIPS & BARKER
CHARTERED

1700 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20006-4723

TELEPHONE (202) 393-7600

FACSIMILE (202) 393-7601
IPB@IPBTAX.COM
WWW.IPBTAX.COM

H. STEWART DUNN, JR.
CARROLL J. SAVAGE
ERIC R. FOX
CAROL K. NICKEL
ALAN WINSTON GRANWELL
LESLIE JAY SCHNEIDER
ROBERT H. WELLEN
KEVIN P. O'BRIEN
JOSEPH DECARLO, JR.*
PATRICK J. SMITH
MICHAEL R. HUFFSTETLER
LAURIE E. KEENAN
JEFFREY E. MOELLER
STEVEN H. WITMER
ROSINA B. BARKER
WILLIAM L. SOLLEE, JR.
JODI H. EPSTEIN
DEAN R. MORLEY
ERIC D. CHASON
ROBIN M. SOLOMON
DIRK J. J. SURINGA
ROBERT G. LORNDALE, JR.

DAVID D. SHERWOOD
AMY D. HEALY
STEFAN PRENTISS SMITH*
H. CARTER HOOD
JENNIFER J. FINN
DANIELLE E. ROLFES*
LISA MILOT
DAMON W. TAAFFE*
VICTOR S. CHANG*

JAMES S.Y. IVINS (1885-1960)
PERCY W. PHILLIPS (1892-1969)
RICHARD B. BARKER (1906-1988)

OF COUNSEL
JAY W. GLASMANN
WILLIAM L. SOLLEE
DANIEL B. STONE
CLIFTON B. CATES III
JEANNIE LEAHY*

LOS ANGELES OFFICE
1925 CENTURY PARK EAST
SUITE 2140
LOS ANGELES, CALIFORNIA 90067
TELEPHONE (310) 551-6633
FACSIMILE (310) 551-1188

*NOT ADMITTED IN THE DISTRICT OF COLUMBIA

FEBRUARY 10, 2004

Re: Administration's Cash Balance Proposals — Alert

Last week, the Administration sent Congress an outline of its proposed cash balance legislation. Many employers will find it disappointing: It restricts future conversions, but fails to clarify the legality of cash balance plans and past conversions under existing law.

Nonetheless, the proposal is now the starting point of any cash balance legislation. Employers who don't want to lose control of the process have little choice but to work with Treasury to secure improvements. This memo recommends what these improvements should be.

The proposal will affect different employers differently. What resolution is best for you will depend on the specifics of your cash balance plan and your own conversion. With legislation a real possibility, you may wish to consider whether you want the outcome to be decided by the employer groups and their diverse constituencies, or whether you want to carry your own case to the Administration and Congress.

I. Summary of Proposal

(1) **Future conversions** to a cash balance formula would be limited as follows:

- If any participant's benefit under the new formula is less than under the old, a 100% excise tax applies to the difference unless all current participants get:
    - The better of the old and new formula, for five years;

- Grandfathered coverage under the old formula, with no time limit; or
- An election between the old and new formula, with no time limit.

- If the "better-of" option is chosen for five years, wear-away of the old benefit would thereafter be illegal, with no time limit. New cash balance accruals would be allowed only as an add-on to the old benefit.
- The excise tax would not exceed the plan's surplus assets in the conversion year, or, if greater, the sponsor's taxable income.
- ERISA and ADEA might also be amended — but this is not clear, and according to Treasury officials has not been decided.

(2) **Age Discrimination** would be "clarified" as follows:

- A cash balance plan is not age discriminatory if pay credits for older participants are no less than for younger ones, presumably as a percent of pay.
- A conversion is not age discriminatory merely because it preserves the value of any early retirement subsidy in the opening account balance.
- Wear-away transitions under past conversions are ***not*** addressed, and their status under the age discrimination rules is not "clarified."
- "Similar" rules would apply to "other types of hybrid plans."

(3) **Whipsaw** would generally be eliminated and Notice 96-8 repealed. For plans with a "market" rate of interest, the lump sum would equal the cash balance account.

(4) **Effective Dates** are very unclear. Generally, the proposal is prospective only. The age discrimination provisions are described as "clarifications" of the law — implying that they are intended to affect existing law. But their effective dates are prospective, and legislative history would state that "no inference" is intended for existing law.

II. What The Treasury Proposal Means for Employers

(1) **Conversions**

- Specific impact. Many cash balance conversions would be made costlier and more complicated.

- Broader impact. For the first time, a Republican Administration has stated that a cutback of future benefit ***expectations*** is "unfair," and a member of the Republican Leadership has signaled public agreement.[1] These statements are a startling reversal of lawmakers' long held position that employers are free to

---

[1] See Statement of John Boehner, Chairman, Committee on Education and the Workforce: "We must work to ensure that all employer conversions to cash balance plans are fair and equitable to younger and older workers alike."

reduce or even eliminate future benefits. A bipartisan agreement now seems possible that all benefit expectations deserve protection.

Once Congress starts its deliberations, it might eventually decide that *all* cutbacks in pension and welfare benefit expectations — not just those arising from cash balance conversions — are "unfair" and subject to the same restrictions.

- Key details very unclear. The proposal is unclear in many important respects. A few examples:

  - What's a conversion? The proposal applies to a "conversion." If the employer freezes or terminates its defined benefit plan and the next year starts a cash balance plan — is this a "conversion"? The details of other key terms are similarly undefined, including "hybrid plan" and "wear-away."

  - Perpetual grandfathers? Except for the five-year better-of rule, the alternative grandfathers seem to apply in perpetuity. Do these grandfathers forever endure to over-ride the employer's ability to amend its plan? If five, ten, or twenty years after the conversion, the employer in any way amends the plan, is the conversion protection blown up? So it seems — but it is unclear.

  - Sales, mergers, etc. These apparently perpetual grandfathers — do they survive if the grandfathered formula is merged into another plan, or transferred to another employer pursuant to a corporate sale or reorganization? The same question arises with the apparently perpetual ban on wear-away. Again, the answer is unclear.

(2) Age Discrimination

- Guidance halted. Employers should expect no further guidance from Treasury to save their cash balance plans from age-discrimination law suits. The issue is now in the hands of the courts and Congress.

- No retroactive effective date. By failing to include a clearly retroactive effective date, the proposal threatens to make existing law ***worse***. On the one hand, it purports to "clarify" existing law. But it also promises that the measure's effective date is prospective only, with "no inference" language for prior years. Our quick survey of case law shows that courts tend to read "no inference" clauses to imply that Congress intended to change the law and apply the new law prospectively only. One appellate court, for example, concluded that a "no inference" clause in REA's legislative history made certain ERISA amendments prospective, even though legislative history also

said that the new provision was intended "clarify" existing law.[2] In short, the court read a "no inference" clause to trump a "clarify" clause. **Without a clear retroactive effective date, the new legislation could well lead courts to conclude that existing law makes cash balance plans age-discriminatory.**

- Past wear-aways not addressed. Even if the "clarify" language helped make the proposal retroactive, the proposal does not purport to "clarify" the legality of wear-away conversions. This omission makes the proposal's inference especially troublesome as to the legality of past wear-aways.

- Proposed regulation not rescinded. Treasury last year issued a proposed regulation governing age-discrimination in pension plans. As a general rule, the proposed regulation states that age discrimination in a defined benefit plan must be measured in terms of the age-65 annuity. The general rule makes ***all hybrid plans illegal,*** including cash balance plans, pension equity plans, and floor-offset plans. Cash balance plans are exempted under a special exception, but only if they meet a strict design test. Treasury has not rescinded the proposed regulation. The proposed rule thus remains, with its troublesome implication that cash balance plans are illegal without a complicated exception that has not yet become law.

- Proposed regulation all over again? The proposal fails to specify what its "clarified" age-discrimination rule would be, stating only that cash balance accruals would be tested like contributions to a defined contribution plan. This is very unclear, but could be read as a revival of last year's troublesome proposed regulation.

(3) **Whipsaw/Notice 96-8**

- Its inclusion here shows that Treasury has abandoned efforts to repeal Notice 96-8 by issuing regulation or other guidance.

- For employers who don't mind its prospective effective date, it appears to clear up most whipsaw problems.

III. What Employers Should Do

(1) **Long term planning.** In evaluating long term pension strategies, employers should take into account the growing likelihood that Congress may in the next few years restrict their ability to amend their pension plans to cut back future benefit expectations.

[2] *American Stores Co. v. American Stores Co. Retirement Plan*, 928 F.2d 986 (10th Cir. 1991).

(2) **Lobbying**. In deciding how to respond to the proposal, employers should keep the following principles in mind:

- Non-enactment is best. For most employers, we believe that non-enactment of this package would be better than enactment in its current form. It adds future restrictions, but gives no past certainty.

- But compromise may be more practical. Rather than shut themselves out of a process likely to move forward without them, employers may prefer work with Treasury by promoting some or all of the following improvements:

    - Conversion restrictions finite. The proposal's restrictions on post-conversion plan amendments are too open-ended — indeed even eternal. They should be finite. All grandfather protections should expire five years after the conversion. For employers who choose the five-year "better-of" option, the ban on wear-aways should likewise expire after five years.

    - Protected group smaller. The conversion restrictions apply to every plan participant — an inexplicably broad group. Contrast with Senator Harkin's bill (S. 825), which provides that upon a cash balance conversion, certain participants must be allowed to elect the old formula, but only those at least 40 years of age, with 10 years of service. The protected group should be confined to older, longer service employees.

    - Retroactive effect. The age discrimination rules should be a "technical correction" to the age discrimination statutes, retroactively effective as if enacted with the 1986 legislation,[3] to defeat any inference that cash balance plans are age-discriminatory under existing law.

    - Protect past wear-aways. Legislation should also clarify on a retroactive basis that the wear-away transitions of past cash balance conversions are not age discriminatory. (One caution to think about: retroactive clarification might be given only with a retroactive quid pro quo.)

    - Rescind the proposed regulation. The proposed regulation issued last year articulates a general rule that makes all cash balance plans and other hybrid plans age-discriminatory. While it sits out there as Treasury's arguable interpretation of existing age discrimination laws, its effect for employers can only be troublesome. It should be withdrawn.

---

[3] Public Law 99-509 (1986).

- Workable general rule going forward. The clarified age discrimination rule should not follow the model of Treasury's proposed regulation. That is, it should not measure age discrimination in terms of the age-65 annuity, requiring innumerable specific exceptions for specific hybrid plan designs. Rather, it should articulate a general rule that makes hybrid plans legal.

  A workable general rule could follow any of several existing models already out there. One possible approach is a general test requiring that plans be facially age-neutral. The ERISA Industry Committee (ERIC) strongly promoted this approach as an alternative to Treasury's proposed age discrimination regulation of last year.

  An alternative approach would clarify that the age discrimination rules can be met on an equal-benefit ***or*** an equal cost basis. This would protect most cash balance plans, as the hypothetical account balances would pass on an equal-cost basis.

  A third possible approach would provide that a plan is not age-discriminatory merely because the age-65 benefit is calculated by reference to an index such as interest rates or inflation. To see how this would work, recall that cash balance plans have been called age discriminatory because the age-65 benefit is calculated by growing the hypothetical account balance at a stated interest rate. When measured as the projected age-65 benefit, the same account balance is larger for a younger person than an older because the projected interest credits grow over a longer period of time. Under the approach suggested here, the age-65 benefit would not be age discriminatory, because the general rule would ignore age-65 benefit differences attributable to interest rate indexing. This rule would also automatically save most other "hybrid" arrangements from the age discrimination rules, as well as any plan with an indexed benefit feature.

IV. Conclusion

Now that Treasury has advanced its proposal, cash balance legislation looks like a real possibility. Employers may now have their last clear chance to affect the outcome.

In the past, employers have let industry groups take on the controversy and adverse publicity of cash balance lobbying. But the proposal and its resolution will affect different employers differently. What kind of compromise legislation is best for you will depend on your own plan's design, and the specifics of your own cash balance plan conversion. Rather than await the compromise solution of the industry groups and their many different constituents, you

may want to carry your own case to Treasury and Congress. We can help you with this task, if you wish.

Ivins, Phillips & Barker will be scheduling a meeting with Treasury representatives to discuss the Treasury proposal, and we would welcome any clients who would like to join us.

In the meantime, if you have any questions about the Treasury Department's cash balance proposal, please give us a call: Kevin O'Brien, Mike Huffstetler, Laurie Keenan, Rosina Barker, Will Sollee, Jodi Epstein, Dean Morley, Eric Chason or Robin Solomon, at 202 393 7600, or in our California office, Steve Witmer at 310 598 2057.