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July 22, 2009

Fry v. Exelon: How Will the IRS React?

In *Fry v. Exelon Corporation Cash Balance Plan*, 571 F.3d 644 (7th Cir. 2009) (Easterbrook, J.), the Seventh Circuit affirmed a district court's conclusion that an employer may define the "normal retirement age" of employees participating in the company's pension plan as the completion date of a stated number of years of service rather than attainment of a specified age such as "age 62." This came as welcome news to cash balance plan sponsors who had adopted service-based retirement ages as a means of complying with IRS Notice 96-8. However, significant risk and uncertainty remains.

The problem is that the IRS does not agree with, and is unlikely to follow, the Seventh Circuit's holding. Following publication of the *Fry* district court decision in 2007, the IRS continued its practice of challenging cash balance plans identified on audit that define normal retirement age by reference to years of service. Revenue agent reports issued in connection with these audits made it clear that field agents were following an IRS National Office directive on the issue. For instance, take the following IRS audit report issued to a cash balance plan sponsor in June 2008, challenging the validity of a normal retirement age defined as the earlier of 2 years of service or age 65:

> The Government believes that the Plan does not contain a valid "normal retirement age" [and] therefore does not meet the requirements of IRC

> 411(a)(8) and IRC 401(a)(7). In *Laurent v. Price Waterhouse Coopers LLP* the court ruled a normal retirement age "cannot be defined in reference to years of service." [T]he Plan's reference to only "two years of service" cannot be held to be a valid retirement age. Revenue Ruling 78-120 also requires that a participant must reach a "certain specified age." This Plan does not require such and therefore does not contain a valid retirement age. We believe the [district] court in *Fry v. Exelon* erred.

Revenue Agent's Report (Form 886-A), June 2008.

There is little reason to believe that the Seventh Circuit's affirmance of the *Fry* district court decision will cause the IRS to change its position. The IRS has never felt itself bound by a single Circuit Court decision, and is particularly unlikely to defer to a decision that did not take into account – because the court no doubt was not aware of – the IRS's position.

In fact, the IRS seemingly has little choice but to stand by its position that *Fry* was wrongly decided. The Seventh Circuit held that the ERISA statute imposes no constraints on the manner in which a plan sponsor may define "normal retirement age" under the plan. Yet the IRS has issued regulations that condition tax qualification under Code § 401 on a pension plan's agreement to use a normal retirement age that is "not earlier than the earliest retirement age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed." *See* Treas. Reg. § 1.401(a)-1(b)(2)(i). If Judge Easterbrook is correct that the statute does not include any constraints on the manner in which a plan may define "normal retirement age," these regulations are invalid – even prospectively. *See, e.g., Nat'l Cable & Telecom. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982 (2005) ("A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference . . . if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion").