Cash Balance Plans and ADEA: IRS Proposes Regulations under Code Section 411(b)(1)(H)

Kevin P. O'Brien and Rosina B. Barker

Some commentators have charged that cash balance plans violate the age discrimination rules of the Code, ERISA, and ADEA. The charge applies both to the basic cash balance structure, and to some conversion techniques used when a cash balance formula replaces a traditional one. A new proposed Treasury regulation seeks to affirm the legality of cash balance plans, and some conversions, under the age discrimination rules. The proposed regulation is a good start in clarifying the law. But it arrives at its destination only by proposing a sweeping general rule that affects all defined benefit plans. The legality of cash balance plans is acknowledged only by special exceptions to the general rule. In this article, we explain the proposed general rule, its legal flaws, and adverse effects. We also explore the special rules for cash balance plans and their limitations. We note that a host of additional special rules are needed to save many other common plan designs from failure under the general rule. Many of these designs are expressly blessed by the statute, case law, legislative history, and other authority. We conclude by observing that when the exceptions have more support than the rule, it is time to scrap the rule. We urge the Treasury to return to the drawing board and devise a general rule that has the support of policy, practice, and legal authority.

"Age does not wither her nor custom stale her infinite variety."

Age may not have hurt Shakespeare's Cleopatra, but under proposed new IRS rules, it might invalidate her pension benefit formula, even if the formula is generous, protective, and legal under all other authority.

It is a rare day when a proposed IRS regulation rates national headlines—especially one on such a seemingly dry topic as the "rate of benefit accrual" under a defined benefit plan. But that is just what hap-

Kevin P. O'Brien and Rosina B. Barker are partners in the Washington, D.C., law firm of Ivins, Phillips & Barker. Mr. O'Brien and Ms. Barker specialize in employee benefits and executive compensation. They are contributing editors of ***Benefits Law Journal.***

pened when proposed regulations were published under Code Section 411(b)(1)(H). "Treasury Department rewrites pension rules," trumpeted the headlines. If you did not know better, you would have thought that the IRS had single-handedly scuttled all of ERISA's protective provisions. Depending on your point of view, however, the headline could have been quite different. "IRS tries to create reasonable compromise among warring interests in raging cash balance plan debate, but overrules two federal court decisions and inadvertently wreaks havoc on many plans." We believe the second is closer to the mark.

The proposed regulation supports the broad proposition that cash balance plans, and benefit "wear-aways" that arise when conventional defined benefit plans are converted to cash balance plans, do not always violate the age discrimination prohibitions of Code Section 411(b)(1)(H). But the regulation gets there only after first proposing a strict new age discrimination rule for defined benefit plans of all types. The new rule invalidates many common benefit arrangements—including all cash balance plans. Only a set of special exceptions saves some cash balance plans, and some kinds of conversions.

By proposing a general rule that requires a set of very narrow and specific exceptions to get to its ultimate goal, the proposed regulation creates more problems than it solves. Each single problem can be solved of course—as was done for some cash balance plans—by addition of more special rules and exceptions. But a series of specific fixes would be complicated, and it would obscure the more important point. Special rules are needed only because the new general rule causes so many problems. But the general rule itself is devoid of support in the statute, legislative history, case law, or other authority. And while disrupting so many common arrangements, the general rule does not apparently outlaw any particular problem widely thought to be age-discriminatory. That is, in trying to support the cash balance plan concept (with real, if still incomplete success), the Treasury may have created many more controversies—all of them problems that did not have to arise as a practical matter, and should not have as a legal one. We end this article by concluding that the general rule is so flawed at heart that it should be scrapped and rewritten in its entirety.

SPLIT JURISDICTION

Code Section 411(b)(1)(H) has been especially problematic for the executive agencies because of the overlapping federal law on this point. In addition to the tax provisions of Code Section 411(b)(1)(H), similar, but not identical provisions are in ERISA and the Age Discrimination in Employment Act (ADEA). The different government constituencies reflected in the different regulatory groups—the IRS, the Labor Department, and the Equal Employment Opportunity

Commission (EEOC)—have made it especially difficult for the executive branch to form a consensus. One surprising aspect of the proposed regulations is the apparent agreement of the three agencies on the position taken in the regulation; the preamble notes that the Treasury Department "consulted" with the Labor Department and the EEOC in fashioning these rules. This reflects an improvement over the original 1987 and 1988 proposed regulations on this topic that were published by the EEOC and IRS separately. Those earlier regulations included significant differences in the proper interpretation of the effective date of the rules.[1]

INFLEXIBLE GENERAL RULE

This is our fifth *Journal* article on cash balance plans. Our four previous efforts addressed a variety of topics, including political aspects of these plans, and more technical issues involving their legality under the age discrimination rules.[2]

We concluded that cash balance plans do not violate the age discrimination prohibitions of Code Section 411(b)(1)(H)—neither in their general structure, nor in the controversial "wear away" transition device sometimes used when a cash balance formula replaces a traditional defined benefit formula. Our conclusion was based on several basic points of statutory interpretation: We argued that the "rate of benefit accrual" in Code Section 411(b)(1)(H) does not necessarily mean the rate in the growth of the Code Section 411(a)(7) "accrued benefit."[3] We argued that "rate of benefit accrual" requires examination of each formula in isolation, without regard to netting by other (permitted) formulas. In addition, we contended that the "rate of benefit accrued" should not be interpreted on a strict yearly basis without regard to what happens in another year.

Perhaps proving only that Treasury and IRS staffers must have allowed their *Journal* subscription to lapse a couple of years ago, the newly proposed regulations do not accept any of our arguments. Instead, the proposed regulations articulate an inflexible test of "accrual" generally based on the year-by-year growth in the net accrued benefit at normal retirement age. For brevity's sake we generally use this term interchangeably with the "accrued benefit" and the "age-65" benefit.

As its starting point, the proposed regulation takes the position that the statutory requirement applies to participants of all ages and is not limited to participants who work after attaining normal retirement age.[4] The proposed regulation is at odds with *Eaton v. Onan Corporation,* 117 F.Supp. 2d 812 (S.D. Ind. 2000), which holds that the statutory rule is intended to apply only to accruals after normal retirement age.[5]

For participants who have not attained normal retirement age, the proposed rule provides that the "rate of benefit accrual" is measured by the increase in the participant's accrued normal retirement benefit—generally, the age-65 benefit expressed as an annuity.[6] The regulation then provides that a plan will violate Code Section 411(b)(1)(H) *if any* participant's yearly accrual rate—even the accrual rate for a hypothetical participant who does not exist in the plan population—would be lower solely as a result of the individual being older.[7] Put another way, this means that if two hypothetical employees are alike in service, pay, and all other respects except age, but the rate of growth of the age-65 benefit is higher for the younger than the older in any one year, then the formula fails.

The inflexilbe year-to-year test of the net age-65 benefit on a participant-to-participant basis under the general rule raises a host of issues. Specifically, we think its troublesome features are these: its insistence on testing the age-65 benefit; its insistence on testing the accrued benefit on a net basis, rather than disregarding certain offsets; its insistence on year-by-year testing, rather than a spread out or averaged approach; and its premise that the test be conducted by comparing one participant with another, rather than by looking at the change in benefit accrual for a single participant as he or she ages.

Because the problems raised for cash balance plans arise from the more general problems created by the general rule, we start with that before moving to our more specific discussion of cash balance plans.

THE PROBLEM WITH TESTING THE AGE-65 BENEFIT

The cornerstone of the general rule—and its fundamental flaw—is that it tests the "rate of benefit accrual" by measuring the age-65 benefit, rather than the immediate benefit. As a technical matter, the proposed regulation departs from the statute on this point. The statute, legislative history, and case law all demonstrate the contrary conclusion—that the rate of benefit accrual is not the rate of growth in the age-65 benefit.

The statutory evidence for our conclusion is straightforward. Section 411(b)(1)(H) states that early retirement subsidies may be disregarded in determining benefit accruals for purposes of the age discrimination rule. The early retirement subsidy is not part of the "accrued benefit." The exception would thus be unnecessary had Congress intended the rule to apply to the accrued benefit. Standard principles of statutory construction compel the conclusion that "rate of benefit accrual" therefore does not signify the rate of growth in the accrued or age-65 benefit.

Legislative history confirms our reading of the statute. The relevant ADEA Conference Report contains a single example of a plan that complies with the new rules included in Section 411(b)(1)(H). This hypothetical plan pays participants an annuity of $10 per month per year of service, so that an employee who retires with 10 years of service at age 65 is entitled to an annuity of $100 per month. According to the Conference Report, compliance with the age discrimination rules after age 65 requires that the participant continue to earn an additional $10 per year of service, even after age 65. That is, the ADEA-complying annuity is described in terms of its immediate value, and not in terms of the equivalent age-65 annuity. Otherwise, for actuarial reasons, the immediate annuity after age 65 would need to be *larger* than $10 per year and the example in the Conference Report would make no sense.[8]

The court in *Eaton v. Onan Corporation* concluded that ERISA Section 204(b)(1)(H), the counterpart to Code Section 411(b)(1)(H), "may permit, but do[es] not require," the use of an age-65 annuity to determine an employee's rate of benefit accrual. It is equally acceptable, the court reasoned, to look to the benefits payable at termination of employment, which the court concluded "appears to provide a reasonable mechanism for measuring [an employee's] 'rate of benefit accrual'" under ERISA Section 204(b)(1)(H). The benefit payable at termination of employment included a life annuity commencing immediately, as well as a lump-sum benefit.

On a practical level, the proposed rule fails because it invalidates so many plan designs of widespread and longstanding use. If any of these are to be saved for reasons of politics or policy, the regulation must perform complicated gymnastics to get there.

For example, the drafters decided to leave alone the common practice of defining accruals after age 65 in the same nominal terms as before that age. A 2 percent-of-compensation per year-of-service formula does not become a 2.5 percent formula after age 65 merely because that larger accrual after age 65 is the actuarial equivalent of the rate at age 65. (As we have seen, legislative history expressly contemplates that the nominal rate of "accrual" may continue after age 65 as before, without adjustment to the age-65 equivalent value.) To accommodate this practice (and legislative history), the regulation must switch to a new definition of "rate of accrual" after normal retirement age. This new definition is based on the "normal form"—in this case, the stated 2 percent rate. The "normal form" is a concept nowhere expressed in the statute or legislative history, but must be imported here just to rescue the post-age-65 benefit from failure under the general rule.

Many other common designs also fail the general rule, but are not salvaged with special exceptions. To gauge the magnitude of the problem, one must understand that *any* defined benefit plan design fails the general test where the benefit measured currently is indexed—be it according to inflation, interest rate, wage growth, or any other measure that takes into account the time value of money. The general reason is that, for any formula that is indexed to a stated age (typically age 65), a younger participant always has more years of future indexing embedded in his or her current benefit than does an older participant.

Social Security is perhaps the most common retirement benefit that is indexed before retirement. The Social Security old-age benefit earned each year is indexed by subsequent growth in national average wages. Of course, Social Security is not subject to the age discrimination rules, but if it were, it would fail the proposed general test because of this indexing—a result we think Congress would find at least surprising.

The cash balance plan design is another well known instance of a plan design that indexes benefits before retirement. Assume two cash balance plan participants with identical service, pay, and opening account balances, one age 45 and one age 55. Each is credited with an additional $100 to his or her account. Like all cash balance plans, the $100 is credited with interest—i.e., it is indexed—until age 65, at a rate we assume to be 5 percent. When measured as the age-65 benefit, the indexed $100 accrual is $265 for the 45-year old, and only $162 for the 55 year old (in age-65 annuity terms, $33 versus $20 per year). To be saved from the effects of the general rule, cash balance plans thus need special exceptions that we describe later in this article.

Other plan designs with indexing features present the same problem for the same reason. For example, consider the indexed career average plan. A typical plan formula might provide for an increase in the age-65 annuity by 1 percent of the participant's pay for a plan year. The accrued annuity is increased each year until the annuity starting date, based on the use of an index. The indexing is designed to preserve the economic value of the benefit. But, as in all indexed formulas, the younger participant has more years of indexing ahead of him than does the older participant. More years of indexing means that the younger employees' age-65 annuities will be greater than the older employees' age-65 annuities and the formula thus fails the proposed general rule.

The "pension equity" benefit formula provides a similar problem. A typical pension equity formula provides for age-weighted benefit credits, e.g., 4 percent for each year of participation under age 30, 5 percent for participation at ages 30-35, 6 percent at ages 35-40, 8 percent at ages 40-45, and 10 percent after age 45. The total accumulated percentage a participant has earned is then multiplied by the participant's final average pay to obtain an immediately payable lump-sum benefit. The lump sum also can be converted to an annuity. As with the cash balance plan, the pension equity plan typically indexes the lump-sum benefit for periods after a participant terminates employment. Since younger terminees have more years of indexing than older ones, indexing causes the plan to fail the general test.

Plans that require employee contributions are a further example of the indexing problem. Contributory plans present a problem because the statutory provisions of ERISA and the Code require a minimum benefit based on a two-step process. First, the participant's employee contributions are credited with a legally mandated interest amount (120 percent of the so-called Federal mid-term rate) until the annuity starting date.[9] These accumulated employee contributions are then converted to an annuity. Again, younger participants have more years of interest crediting ahead of them than do older workers. The age-65 annuity attributable to the employee contributions will thus be larger for younger workers than older workers, and the formula fails the general test.

Particularly telling here is that the indexed treatment of employee contributions is mandated by the Code and ERISA. So without a special rule for such contributions, the proposed regulation is in conflict with the statute. The statutory conflict shows that the general rule could not be right. And even if Treasury fashioned a special exception to deal with contributory plans—as it did for cash balance plans—to what end? The basic problem would remain that under the general rule, all indexed formulas are prohibited as age discriminatory. But this result makes no policy sense. These forms of benefit preservation are protective, and should be encouraged rather than prohibited.

In short, the statute, legislative history, practicality, and policy concerns all argue the same conclusion: The "rate of benefit accrual" should not be defined as the rate of growth in the age-65 benefit.

THE PROBLEM WITH NETTING

A second legal and technical difficulty with the proposed general rule is that it requires benefit accruals to be tested on a net basis, without disregarding offsets. This rule is contrary to authority and invalidates a variety of arrangements of longstanding common usage and legal support.

Rule Overturns Lunn

The IRS's proposal to test a participant's net accrual under a plan on a year-by-year basis would overturn the Seventh Circuit's holding in *Lunn v. Montgomery Ward,* 166 F.3d 880 (7th Cir. 1999), which we described in some detail in our Spring 2002 *Journal* article. *Lunn* involved a floor offset plan, that is, a plan that combines a defined benefit formula and a defined contribution formula. In *Lunn,* the defined benefit accrued at the rate of 1.5 percent of compensation for each year of service; this benefit was offset by the benefit that would be provided by the defined contribution formula. Mr. Lunn complained that the plan formula discriminated against participants over age 65. His complaint stemmed from the fact that the annual benefit under the defined benefit formula was offset by the *annuitized value* of the account balance in the defined contribution account. For any two participants of identical pay and service who continued working after age 65, the offset was greater for the older than the younger participants *solely* because of age (after age 65 the same account balance yields a larger annuity for an older employee than a younger employee because of the younger participant's longer life expectancy). Mr. Lunn charged that the systematically increasing offset of the post-age-65 benefit violated ERISA Section 204(b)(1)(H), the ERISA Title I counterpart to Code Section 411(b)(1)(H).

The Seventh Circuit acknowledged the mathematical result of the offset formula and held that the offset did not violate ERISA Section 204(d)(1)(H), even though it correlated with age. The court held that the *rate of benefit accrual* was not affected by the offset and noted that the participant after age 65 was treated the same as younger workers because the participant "kept accruing benefits in exactly the same way he had been doing before he turned age 65." In other words, there was no violation of ERISA Section 204(b)(1)(H) because Mr. Lunn's "rate of accrual" remained the same before and after age 65. The Seventh Circuit based its holding on the reasoning that the "rate of benefit accrual" is applied to the defined benefit and the defined contribution formulas separately—and not to the formulas netted together. The *Lunn* court also looked at the defined benefit formula and concluded that the plan formula passed legal challenge because it was age-neutral on the face.

The Service did not mention the *Lunn* case in the preamble to the proposed regulation, but it is clear that the Service understands the effect that the yearly accrual test will have on floor-offset plans such as that in *Lunn.* In the preamble to the regulation, the Service solicited comments about the effect of the proposed test on floor offset plans and whether these plans should be carved out for special treatment. Comments are requested on whether the "rate of benefit accrual" for a floor offset plan (as described in Revenue Ruling 76-259, 1976-2 B 111) should be tested before application of the offset and, if so, under what conditions. Had the regulation's general rule instead followed *Lunn*, the addition of yet another special rule would be unnecessary.

Netting Disrupts Many Formulas

Defined benefit plan formulas often involve a variety of benefit offsets, and many of these arrangements may violate the test articulated in the proposed regulations. For example, floor-offset plans, like the plan in *Lunn,* involve a defined contribution plan in which the benefit provided by the defined contribution account is offset against the defined benefit plan. Other common offsets involve such things as U.S. and foreign social security benefits, foreign pension benefits, workers' compensation benefits, and nonqualified deferred compensation amounts.

For a look at the purely practical problems of measuring the effects of offsets on the net accrual, it is useful to compare how offsets are handled by regulation under the antidiscrimination rules of Code Section 401(a)(4). Generally, these call for a comparison of the "normal accrual rate" between highly and nonhighly compensated employees.[10] Regulations under Section 401(a)(4) address a variety of benefit formula offsets, including offsets from other qualified defined benefit plans, offsets from defined contributions plans (floor-offset plans), and offsets of foreign plans and other nonqualified plans. To a significant degree, the Code Section 401(a)(4) regulations avoid the difficult task of deciding which years' accruals are affected by the offsetting item, however, by ignoring the offset altogether. Those offsets ignored include all offsets that correlate with grants of past service and preparticipation service.[11] Other types of offsets are supposed to be taken into account in determining the accrual rates for testing purposes, but, in our experience the question hardly ever comes up as a practical matter. This is because the various rules allowing rounding of accrual rates and "substantiation quality data" do not require total precision in the testing regime. The proposed test under Code Section 411(b)(1)(H) calls for total precision because it appears that a lower accrual rate for one older plan participant—even a hypothetical participant—can spell a disqualifying failure for a plan.

THE PROBLEM WITH YEAR-BY-YEAR TESTING

The problems created by the rule's insistence on measuring the net accrued benefit are exaggerated by another feature of the rule: its insistence that the test be satisfied on a year-by-year basis, rather than on a spread-out or averaged basis. Like other basic features of the general rule, this runs into legal as well practical obstacles.

Under the year-by-year testing concept of the general rule, plan sponsors must determine what year a particular offset arises against the formula. This is important because no rule dealing with offsets has hitherto required anyone to determine the exact year the offset affects the plan. For offsets of many kinds, we doubt the conceptual framework exists to determine exactly when it arose—let alone the administrative machinery to administer it.

For example, consider how regulations treat offsets for purposes of determining whether an impermissible forfeiture arises under Code Section 411(d)(6). Regulations distinguish between a case where a plan formula contemplated a possible future offset and the case where a benefit accrued under a plan and an offset provision was added to the plan for the first time after a participant had accrued a benefit. As long as the plan contemplated a possible redirection of benefits by way of an offset, there is no accrued benefit reduction because the offsetting item eventually comes into being.[12] That is, the rules here focus on *when* an offset provision was first added to a plan. They have never asked *which particular years' accruals* were affected by the offset.

Regulations under Section 401(a)(4) offer another interesting comparison to the proposed regulations under Code Section 411(b)(1)(H). The former demonstrate a far more practical approach to determining a participant's "normal accrual rate." Under the nondiscrimination rules, the employer can choose the time period over which to determine the "normal accrual rates" for a plan population. The nondiscrimination regulations offer three choices: (1) the current plan year, (2) the current plan year and all prior years (accrued to date method), and (3) the current year and all prior and future years (projected method).[13] That is, in contrast with the proposed rule, regulations under Section 401(a)(4) permit testing over a period of years on an averaged basis.

By requiring the plan to determine the exact year in which the offset arises, the proposed rule is requiring plan sponsors to determine a question that has not before been determined—and may not even be determinable, even as a theoretical matter. The proposed regulations offer no guidance on this important point, however. Assume, for example, that a participant earns a benefit under a foreign pension scheme, a foreign law, or even under a nonqualified U.S. plan. Does the offset come into play as the participant accrues the benefit, when the participant vests in the foreign benefit, or when the benefit is payable? If the offset only comes into play for this purpose when the benefit vests, and the benefit vests only at a certain age, there would be a problem under Section 411(b)(1)(H).

Moreover, testing on an annual basis rather than over a period of years results in the failure of any formula that is only "catching up" younger workers to a formula that previously favored older workers. During the "catch up period," the rate of benefit growth of younger workers will be greater than that of older ones. These remediation or "level playing field" efforts thus all flunk the general test.

In our Spring 2002 *Journal* article on cash balance plans, we gave the example of a nonelective window program where all participants over age 55 automatically receive three additional years of service for purposes of determining their normal retirement benefit. This advance in the participants' accruals is designed to induce participants to retire early. It works as an early retirement incentive because the affected plan participants will then be in an accrued benefit "wear-away" over the next few years as the benefit calculated under the plan's regular formula catches up to the enhanced benefit. Under the proposed regulation, this plan will fail the yearly accrual test because the accrual standstill during the "wear-away" period applies only to participants over age 55. The same kind of phenomenon would occur if a plan changes accrual methodologies under the antibackloading rules and, for example, a plan changes from a fractional accrual method to a unit credit method.

We believe this result is wrong from a technical perspective and perverse from a policy one. We do not believe that employers' efforts to catch-up younger workers with older ones was intended by Congress to be prohibited age discrimination, or should be one as a policy matter.

In the preamble to the proposed regulation, the Service asked for specific comments on the question of whether the "rate of accrual" should be tested on something other than a yearly basis and whether, for example, accrual rates can be determined by averaging participant accruals over a period of years.[14] This solicitation of comments on averaging techniques is interesting, since the yearly-testing idea is the lynchpin for the Service's attack on "wear-away" plan conversions. (We explain why this is so below.) Nevertheless, the apparent willingness of the government to consider another approach is important. As we have noted, the similar exercise under the nondiscrimination rules of Code Section 401(a)(4) allows for three different methods of calculating a participant's "rate of normal accrual," so there may be room for more flexible rules under Code Section 411(b)(1)(H) as well.

THE PROBLEM WITH PARTICIPANT-TO-PARTICIPANT COMPARISONS

The fourth problem with the general rule is its insistence that the test be conducted by comparing any older participant against a younger participant, rather than by comparing the change in benefit accrual of the same participant. That is, if two real or hypothetical participants have the same pay and service history, but differ in age, the rule is violated if the accrual rate of the older employee is less than that of the younger.

There is no statutory basis for this participant-to-participant approach. Section 411(b)(1)(H) requires that the rate of *"an employee's benefit accrual"* may not be reduced on account of age. On its face this looks like a prohibition against reduction of the accrual rate for any individual as he or she ages.

By contrast, consider the regulations under Section 401(a)(4) that compare the rates of benefit accrual by highly compensated employees and nonhighly compensated employees. The statutory authority behind this rule is different. Section 401(a)(4) prohibits discrimination "in favor of highly compensated employees." Unlike Section 411(b)(1)(H), that is, Section 401(a)(4) on its face arguably compels a comparison between one group of employees (high paid) and another (low paid). Section 411(b)(1)(H) by contrast couches its rule in terms of a single employee.

Legislative history confirms our conclusion that Section 411(b)(1)(H) measures only discrimination against any single employee as he or she ages, rather than any single older employee against any single younger employee. To see this, assume a fractional accrual final pay plan formula that provides for 1 percent of final pay for the first 20 years of service, plus 2 percent of final pay for service in excess of 20 years. If one employee is hired at age 35 and another at age 45, the accrual rates of the two participants upon plan entry will be 1.33 percent for the 35 year old and 1 percent for the 45 year old. The regulation concludes that this formula violates Code Section 411(b)(1)(H) because the older worker with the same pay and service history as the younger participant has a lower annual accrual rate.[15]

This result is contrary to legislative history, which clearly stated that plans using a fractional accrual rule are intended to satisfy Section 411(b)(1)(H). The legislative history specifically noted that the rate of benefit accrual for a participant may vary depending on the number of years of service an employee may complete between the date of hire and the attainment of normal retirement age.[16]

The fact that the fractional accrual rule in this example flunks the general rule—even though fractional accruals are blessed in legislative history—follows directly from the regulators' decision to test the "rate of benefit accrual" by comparing on a participant-to-participant basis, rather than by the change in accrual rate for any single participant over time. The conflict between legislative history and the results of the general rule confirm our conclusion that the general test is incorrect.

CASH BALANCE PLANS AND THE GENERAL RULE

Now we turn to the proposed rule's treatment of the plans that were doubtless the driving force behind its publication: cash balance plans.

Cash balance plans raise two separate issues under the general rule. First, is the rule violated by the basic cash balance plan design? And second, even if the general design would pass muster as a new plan, is the rule violated when a conventional defined benefit plan is converted to a cash balance plan?

As we have noted, the answer to the first question is yes; without special treatment, all cash balance plans would violate the proposed general rule under Section 411(b)(1)(H). An example illustrating why this is so appears in our discussion above.

The answer to the second question is similar; without special treatment, many types of conversions seem to flunk the test. Curiously, none of the examples set forth in the proposed regulation deals specifically with a cash balance plan conversion. But the general rule means that plan conversions using a "wear-away" transition fail.

A wear-away transition arises when the cash balance formula is adopted to replace a prior defined benefit plan formula, and the starting account under the new, cash balance formula is smaller than what had been communicated to participants as their benefit under the old formula. This might happen for a number of reasons. For example, the interest rate used to discount the old age-65 benefit to its current lump sum equivalent might be lower than the rate used under the new cash balance formula (the lower discount rate produces a larger lump sum, the higher discount rate, a smaller one). Or the plan might compute the starting cash balance account by applying the new cash balance formula retroactively to all the participant's years of service, so the participant enters the plan formula "as if" it had applied since his or her first day of work. Depending on a number of factors, the new starting account balance may be smaller than the lump sum value of the old benefit communicated under the old formula.

When the new lump sum is smaller than the old, one transition device is a wear-away. Under this the participant gets the greater of the frozen benefit under the old formula, or the benefit under the new cash balance formula. Put another way, each participant's benefit under the new cash balance formula is offset by the benefit under the old. There is a resulting period of zero benefit growth measured on a net basis until the new benefit catches up with the old. The period of zero net growth during the catch up period gives wear-away its name.

Wear-away has raised issues under ADEA based on a hypothetical transition posed by some commentators. For example, assume a 50-year old and a 40-year old participant, each with an age-65 annuity of $10,000 per year. Because of the time value of money, the immediate lump sum equivalent is larger for the 50-year old than the 40-year old ($33,381 versus $18,640 under our assumptions). To "wear away" the larger amount, the 50-year old will be in a period of zero net benefit growth for a longer period of time than the 40-year old. Because for at least one year, the rate of growth in the net benefit of the 50-year old will be less than that of the 40-year old in that same year, under the general rule, this wear-away transition flunks Section 411(b)(1)(H).

Wear away transitions flunk the general rule because of several of its individual components. The first such component is the drafters' decision to define the test in terms of the age-65 benefit.

The second is the drafters' decision to compel testing of the benefit on a net basis, rather than ignoring offsets. Without this netting concept, the rate of accrual of the 40-year old and the 50-year old would be the same (measured on an immediate annuity or immediate lump sum basis rather than the age-65 benefit).

The third is the drafters' decision that testing must apply each year, rather than on a spread-out or averaged basis. For example, assume a conversion in which each plan participant is given a starting account balance equal to the *greater* of the lump sum value of the age-65 benefit under the old formula, or the balance he or she would have if the new cash balance formula had been in effect since commencing employment. Employees for whom the old benefit is larger will be in a "wear away" period of zero benefit growth until the "new" formula catches up with the old. But measured over a period of years, older and younger employees will end up with the same average accrual rate—the rate under the new formula.

Consider again our 50-year old and 40-year old employees, with identical pay and service. Although each has the same age-65 benefit, the current lump sum benefit of the 50-year-old is larger than that of the 40-year-old, and his wear away period will thus be longer. But this is only because the 50-year-old starts in possession of a more valuable benefit when measured on a current basis. (That is, the same age-65 annuity is more valuable currently to the 50-year-old than the 40-year-old who must wait longer to receive it.) In fact, even under the cash balance plan, the 50-year-old will always remain in possession of the more valuable benefit, measured on a current basis, and a higher historical accrual rate measured on an average basis over time.

We noted above that the rule's insistence on year-by-year testing of the rate of accrual means that all remediation efforts to undo past discrimination by "catching up" younger employees to older employees fail. This is because in each single year during the catch up period, the accrual rate of the older employee is lower than the younger—even though higher than that of the younger on an averaged basis. Wear away transitions are only a special instance of the general rule's hostility to efforts to level the playing field between older and younger employees.

In short, the trouble incurred by cash balance plans under the general rule—both in their basic design and in wear-away transitions—is the direct result of several distinct design elements of the rule that we have shown all lack legal support, and all have multiple adverse consequences for benefit arrangements of many kinds.

Having invalidated cash balance plans and transitions under the general rule, the drafters then crafted a set of special rules to salvage certain kinds of plans and transitions.

SPECIAL RULE FOR CASH BALANCE PLANS

To deal with the inherent difference between cash balance plans and other types of defined benefit plans, the proposed regulation includes a special rule for "eligible cash balance plans." The special rule recognizes that these hybrid plans are similar to defined contribution plans. Unlike the general rule, which tests the "rate of accrual" for these plans on the basis of the age-65 annuity, the special rule would test the "rate of accrual" by looking at the additions to a participant's hypothetical account for the plan year. In contrast to the general rule, when testing these additions, the special rule would ignore interest credits that are not contingent on the participant's continued service.

To be eligible for the relief provided by the special rule, a cash balance plan must be an "eligible cash balance plan." This means it must meet three requirements.

The first requirement, like the rule for post-age-65 accruals, uses the concept of the "normal form" of the benefit. A new concept, uniquely devised for this proposed regulation, the "normal form" of the benefit is the form in which the benefit is expressed in the plan formula, and the form that is the basis of all benefit calculations. It is not necessary that the benefit actually be payable in the normal form.

Armed with this new concept, the special rule first requires that the normal form of the benefit under the plan must be an immediate payment of the hypothetical account balance. In accordance with the normal form concept, the plan does not have to allow payment in a lump sum, but the lump sum "account balance" must be the form in which the benefit is described under the plan and the place from which calculations of other benefit forms are made. This first requirement of course describes any defined benefit plan that expresses the benefit in the form of a defined-contribution-like account balance. All cash balance plans and some other hybrid plans will typically meet this requirement.

The second requirement is that the right to annual interest credits must accrue without regard to future service. The interest credits must be at a "reasonable rate of interest" and the rate may not reduce with age. This requirement raises a number of questions and poses a problem for a number of popular plan designs. For example, a number of the early cash balance plan designs offered multiple levels of interest crediting, but also offered additional interest credits that applied only while the participant was employed. The linking of the variable rate interest credits to future employment could make the plan ineligible for the special rule.

The "reasonable interest rate" requirement also may affect other plan designs. Some cash balance plans pass through notional investment choices to participants for purposes of determining the yearly rate of return on the hypothetical account. It is not clear that these plans will satisfy the requirement that the "interest credits" represent a reasonable rate of interest.

Perhaps the most popular plan design that will fail to meet the "eligible cash balance plan" definition because of inability to meet the "interest credit" requirement is the pension equity plan which we described previously. The proposed regulation does not explain why pension equity plans are not eligible for the same kind of "rate of accrual" rule as cash balance plans. The preamble addresses the matter obliquely and notes some types of hybrid plans do not provide for reasonable interest credits on the account balance. It notes that these plans will have the "rate of accrual" under Section 411(b)(1)(H) determined under the general normal retirement date annuity rule that applies to traditional defined benefit plans. Informal discussions with Treasury and IRS staff who worked on the proposed regulation suggest that there was no intent to disqualify pension equity plans on the part of government officials.

While the noncoverage of pension equity plans is one of the major surprises and disappointments, it is the third element of the "eligible cash balance plan" definition that is the most surprising, and the most problematic. The third requirement deals with the plan conversion technique used by the plan.

Conversion Restrictions

The technique used to switch participants from traditional plans to cash balance plans has been one of the most politically sensitive issues involved in cash balance plans. The proposed regulations deal with the plan conversions in two ways. First, they spell out safe-harbor approaches for the cash balance plan conversion itself. Second, they deal with plans that include both cash balance and noncash balance formulas after the conversion. Some of the rules on plans with multiple formulas are surprisingly restrictive.

The first set of conversion rules deals with the conversion itself. Companies have tended to handle this in a variety of ways. Some plan sponsors determine a lump sum value of the already accrued normal retirement benefit and use this figure as the opening balance. A less common approach is to go back and set the opening cash balance as the balance it would have been if the cash balance formula had been in effect for all years of plan participation. A number of employers have combined both of these approaches and have determined the opening balance as the greater of these two amounts. All of these approaches could result in an accrual benefit "wear-away."

The proposed regulation blesses two conversion techniques. The first one, which is a "no-brainer," is a so-called "A plus B" approach. Here, the conversion merely adds the new cash balance additions to the accrued benefit under the old formula with the old benefit retained as a normal retirement annuity.[17] This is a no-brainer because there is no wear-away in this case.

The rule setting forth the second permitted conversion technique focuses on the calculation of the opening balance.[18] It provides that the opening cash balance must not be less than the actuarial present value of the participant's prior age-65 benefit, using "reasonable" actuarial assumptions. (The present value must be determined by looking to the "normal form" at age 65, calculated at the later of the conversion plan amendment's effective or adoption date.) If the opening balance of the cash balance account exceeds the present value of the age-65 benefit, the excess is tested as an additional pay credit (an additional accrual) in the year of conversion. Taken together, these two rules as a practical matter mean that the opening account balance may not be less than or greater than the present value of the age-65 benefit. This result is extremely restrictive. We describe below its negative and perverse effect on many common transition arrangements.

The proposal does not spell out what qualifies as "reasonable" actuarial assumptions for purposes of establishing the opening account balance. There had been some concern that the government might mandate the use of certain actuarial assumptions, such as the statutory assumptions under the "spousal consent" rules of Code Section 417(e), but, thankfully, this was not done. The Code Section 417(e) rates, however, are safe-harbor rates for setting the opening balance, as spelled out in one of the examples in the regulation.[19]

The second set of plan conversion rules deals with plan formulas that combine both cash balance and traditional formulas. This rule on so-called "mixed formulas" permits the separate testing of the different component formulas—with the traditional formula tested in terms of a normal retirement annuity, and the cash balance plan as a defined contribution-like account balance addition—if certain conditions are met.[20] The plans can be tested separately in this way if the two types of plan formula are (1) additive formulas (A plus B), (2) the greater of the two formulas with both formulas going forward (greater of formula), or (3) some participants set the cash balance plan formula and others get either the traditional plan, an additive formula of the old and new formulas, or a greater of formula. In no case, however, may any of the separate formulas exclude participants who have attained a certain age.

Assessment of Conversion Restrictions

The restrictions on plan conversions and multiple formulas will protect some, but not all, standard conversion techniques. Those that pass will include one-time choice arrangements in which participants are permitted to choose which formula to accrue benefits under. Many plans also provide that participants at the time of the conversion will get the better of the two formulas; these plans clearly are permitted. Other plans that pass will be those that applied transition pay credits under the cash balance formula, as long as the level of the transition credit does not decline with age.

Other common conversion techniques will fail the proposed rule, for the reason that they set an opening balance which is or could be greater or less than the present value of the age-65 benefit under the old formula. Plans that reconstructed the cash balance plan from the start of plan participation will not meet the rule, since the opening balance may be less than the present value of the previously accrued benefits in many cases. Oddly, plans that set the opening account balance as the greater of the present value of the old accrued benefit or the reconstructed account balance also might fail. This "greater of" approach might fail because the reconstructed account balance might exceed the present value of the old accrual benefit and amounts in excess of the present value of the age-65 annuity have to be treated as an addition to the tested rate of accrual. The failure to bless this "greater of" approach is surprising since this "greater of" approach was explicitly blessed under the Code Section 401(a)(4) regulations.[21]

Another puzzling effect of the rules is the proposed disqualification of transitions that allow employees to keep the value of their early retirement subsidy in the new cash balance account. These also fail because the opening account balance will be larger than the present value of the accrued benefit, which, by definition, excludes the value of the early retirement subsidy. If added to the account balance, the subsidy (like any other excess amount over the accrued benefit) must be treated as an addition to the tested rate of accrual. This means that for any two participants with an early retirement subsidy, the accrual will be larger for the younger than the older (because the value of the subsidy diminishes over time).

In addition, any conversion technique with an age-related grandfather provision will fail. For example, if all employees over age 55 at the time of the conversion are kept on the old traditional formula and employees under age 55 are converted to the cash balance plan under the regulation-blessed "opening balance" approach, the plan does not pass the conversion rule. This is because the cash balance plan is tested as if it is a separate plan that violates the maximum age exclusion of Code Section 410(a)(2).[22] Oddly, this result is in part a matter of plan drafting. This complete grandfather approach could be used in this instance if the plan had a normal retirement date of age 60. In this case, the maximum exclusion would not be violated if employees within five years of "normal retirement age" were excluded from the new formula.

Finally, one common transition technique fails because of the special rule's surprising requirement with regard to the treatment of participants already over normal retirement age at the time of plan conversion. Many plans have used the participant's attained age in setting the participant's opening account balance. This means that the participant gets a smaller opening balance at age 70 than would have been available at normal retirement age; this difference reflects the shorter life expectancy at age 70 than at age 65. The proposed regulation does not allow this approach. Instead, the regulation provides that the opening balance for a participant who has attained normal retirement age may not be less than the balance used if the participant were at his or her normal retirement age.[23]

EFFECTIVE DATE

The proposed regulations cannot be relied upon until adopted in final form and are proposed to apply to plan years beginning on or after the date of publication in the Federal Register.[24] One important question about the proposed effective date is how the rule will apply to prior cash balance plan conversions.

This question arises because of the peculiar way the regulations express the special rule for cash balance plans. As we have noted, cash balance plans raise two age discrimination questions. The first is whether the basic design violates the age discrimination rules; the second is whether, assuming the basic design is permitted, wear-away and other transitions violate the rule when a cash balance formula replaces an earlier plan design.

The proposed regulation deals with these two questions together, and appears to provide that a plan will not violate Code Section 411(b)(1)(H) based on the basic status of the plan as a cash balance plan if it meets certain requirements, one of which is that the plan must satisfy the specific requirements for conversions. Having tied the various requirements together, the question is whether the future application of the special cash balance rule is limited to plans that met the plan conversion rules, no matter when the conversion took place.

While a literal reading of the proposed regulation seems to provide for retroactive application of the plan conversion restrictions, there have been informal indications from Treasury and IRS staff that this was not the intent. The proposed regulation includes a variety of requirements that reasonably could not have been anticipated by plan sponsors, so it would be unreasonable to apply these standards retroactively.

Even if the plan conversion standards are not expressly extended retroactively, plan sponsors who did not meet these requirements and who are facing legal challenges by participants have a legitimate concern. These employers worry that a federal judge looking at a conversion might apply these rules retroactively in the absence of any other legal standard.

CONCLUSION

The new proposed regulation is in many ways a good start to fixing a troublesome and growing problem. For many years now, cash balance plans have been under a cloud in part because of some commentators' charge that the plans fail ADEA's age discrimination prohibitions. This cloud has not been completely dispelled despite favorable case law under *Lunn* and *Eaton*, and even despite the IRS's 1991 pronouncement that cash balance plans do not violate Code Section 411(b)(1)(H).

By stepping into this contentious debate, and again endorsing cash balance plans, the Treasury has resumed the leadership role on an issue that was threatening to be taken over by rhetoric, press releases and only the occasional federal court decision. The Treasury clearly gave these plans the green light in 1991, and plan sponsors acted in reliance. The Treasury has now shown its intention to protect companies that converted to cash balance plans in good faith reliance on the Treasury's own previous position.

Moreover, the Treasury's approach to testing the cash balance plan is a sound one in outline form. By measuring the rate of accrual as growth of the immediate benefit, the Treasury has sketched the groundwork for an approach that might work as a general rule.

Nevertheless, the regulation taken as a whole is extremely troublesome. In our view, the entire approach to the regulation should be reconsidered.

Instead of merely laying cash balance issues to rest, the drafters began by creating a universal rule that to our minds is unsound as a matter of law and policy. It invalidates many common plans. Instead of calming one political firestorm, it may have stirred up a hundred. It does all of this without apparently outlawing even one plan or practice where commentators in good faith have agreed "Oh yes, that really was an abuse. Good thing that's gone." And it does all of this without any clear apparent authority in the statute, legislative history, or case law for its interpretation of Section 411(b)(1)(H).

The troublesome general rule means that legality of cash balance plans is acknowledged only by superimposition of special exceptions. The exceptions themselves have boundaries—of course—but the boundaries themselves fail to make any sense. For example, we can divine no technical or policy reason why the special exceptions do not protect cash balance transitions that are designed to enhance participant benefits. This includes cases in which the participant receives the greater of the old benefit and a reconstructed, past service cash balance account, as well as cases where the opening account balance includes the early retirement subsidy. To our minds, companies should not be punished if they took steps to smooth the transition to a new plan formula, and we see nothing to explain the Treasury's contrary position.

Again, we think the problem here is in the general rule. Given its sweeping scope, and powerful effects, the general rule means that any exceptions merely look arbitrary and unprincipled. The real problem, of course, is that it is the general rule that is arbitrary. Proof of this is the many more special rules still needed to support the legality of the plans invalidated under the general rule—even though clearly blessed by statute, case law, or both. Easy examples discussed in this article are contributory plans and floor offset plans. When the exceptions have more support than the general rule—it is time to rethink the rule.

We think the Treasury took a good first step in solving the problems in the cash balance arena created by its own inaction after 1991. But we believe the Treasury took very serious misstep in creating a general rule, universally applicable to all defined benefit plans, that is devoid of legal authority, that has so many disruptive effects on so many plans, that creates a hundred problems for every one it tries to solve—and that, before the end of the day, will require a hundred more special rules for every one it contains now. We believe they should scrap the general rule and start over.

NOTES

1. Notice 88-126, EEOC 1/9/89.

2. *Benefits Law Journal,* Spring 2002, Vol. 15, No. 1, "Cash Balance Conversions under the ADEA—Reconsidered and Reaffirmed"; *Benefits Law Journal,* Summer 2000, Vol. 13, No. 2, "Do Cash Balance Plans Violate the ADEA?"; *Benefits Law Journal*, Spring 2000, Vol. 13., No. 1, "Cash Balance Plans: Are Wear-Away Transitions Legal under the ADEA?"; and *Benefits Law Journal,* Winter 1999, Vol. 12, No. 4, "PensionCabal.com—Ruminations on the Cash Balance Crisis." (All four articles were authored by Rosina B. Barker and Kevin P. O'Brien).

3. We pointed out a couple of statutory provisions that support this idea. First, we noted that Code § 411(b)(1)(B) expresses the statutory anti-backloading rule in terms of the "annual rate" at which the participant can "accrue the retirement benefits *payable at normal retirement age*. In other words, where Congress intended to denote "rate of accrual" as the increase in the normal retirement age benefit, the statute states this identity expressly. Second, we also noted that Code § 411(b)(1)(H) expressly provides an exception to the rate of accrual rule because an early retirement subsidy is disregarded in determining benefit accruals. But an early retirement subsidy is not part of the Code § 411(a) accrued benefit. If the "rate of accrual" in Code Section 411(b)(1)(H) had been intended to denote the rate of growth of the § 411(a) accrued benefit, the exception in Code § 411(b)(1)(H)(v) for early retirement subsidies would be unnecessary and meaningless.

4. Prop. Treas. Reg. § 1.411(b)-2(a)(2).

5. The proposed regulation is also inconsistent with unpublished opinion. In *Engers v. AT&T Corp.,* No. 98-3660 (D.N.J. June 6, 2001), the court dismissed a claim under ERISA § 204(b)(1)(H) because the statute applies "only to those employees who continue to work after the normal retirement age of sixty-five."

6. Prop. Treas. Reg. § 1.411(b)-2(b)(2).

7. 67 Federal Register 76124 (December 11, 2002).

8. H.R. Conf. Rep. 99-102, 99th Cong., 2d Sess., at 381, 1986 U.S.C.C.A.N. at 4026.

9. Code § 411(c)(2)(B).

10. Treas. Reg. § 1.401(a)(4)-3(d)(1).

11. Treas. Reg. 1.401(a)(4)-3(d)(1)(iii).

12. *Vintilla v. United States Steel Corp. Plan for Employee Pension Benefits,* 606 F.Supp. 640 (W.D. PA. 1988), aff'd mem. F.2d 1033 (3rd Cir.) (1989) (qualified pension reduced for nonqualified severance required under foreign labor law); *Pritchard v. Rainfair, Inc.*, 945 F.2d 185 (7th Cir. 1991) (offset for other pension plan benefits); *Dameron v. Sinai Hospital of Baltimore,* 815 F.2d 975 (4th Cir. 1987) (social security offset).

13. Treas. Reg. § 1.401(a)(4)-3(d)(1)(iii).

14. 67 Federal Register 76129 (December 11, 2002)

15. Prop. Treas. Reg. § 1.411(b)-2(b)(3)(iii), Example 9.

16. The legislative history of Code § 411(b)(1)(H) included the following passage dealing with the treatment of fractional benefit accrual rule:

> "Under the conference agreement, the rules preventing the reduction or cessation of benefit accruals on account of the attainment of age are not intended to apply in cases in which a plan satisfies the normal benefit accrual requirements for employees who have not attained normal retirement age. Under the benefit accrual rules, the rate of benefit accrual for an employee may vary depending on the number of years of service an employee may complete between date of hire and the attainment of normal retirement age.
>
> For example, under the fractional benefit accrual rule, an employee may accrue a benefit ratably for each year of service between the employee's date of hire and the employee's attainment of normal retirement age. If a plan has a normal retirement age of 65, under this fractional rule, an employee who is hired at age 45 would accrue the normal retirement benefit between age 45 and age 65 (normal retirement age). Thus, the employee would accrue the benefit over 20 years. On the other hand, an employee with the same salary hired at age 55 would accrue the same normal retirement benefit over 10 year (the number of years between date of hire and normal retirement age). In this example, when both employees have completed five years of service, they will have different accrued benefits because of the different rate of benefit accrual for each year of service. The conferees do not intend that the plan is to be treated as violating the general rule that benefit accruals cannot be reduced or ceased on account of the attainment of age merely because a younger employee has a lower accrued benefit than an older employee with the same number of years of service."

H.R. CONF. REP. No. 1012, at 379 (1986), repeated in 1986 U.S.C.C.A.N. 4024.

17. Prop. Treas. Reg. § 1.411(b)-2(b)(2)(iii)(D).

18. Prop. Treas. Reg. § 1.411(b)-2(b)(2)(iii)(E).

19. Prop. Treas. Reg. § 1.411(b)-2(b)(2)(v) (Example 5).

20. Prop. Treas. Reg. § 1.411(b)-2(b)(2)(iii)(C).

21. The special fresh-start rule for cash balance plans in the Code § 401(a)(4) regulations blessed an approach based on the greater of the accrued benefit or a reconstructed cash balance account. Treas. Reg. § 1.401(a)(4)-13(f).

22. The apparent rationale for applying the Code § 410(a)(2) maximum-age exclusion separately to the two plan formulas is that the plan should not be able to do in one plan what it cannot do in two plans. This is not a very strong argument. Many plan formulas include some sort of step-rate after a participant has been in the plan for a set number of years. For example, a plan might provide a benefit of 1 percent of pay for the first 15 years of service and 2 percent for each year of service thereafter. No one ever has suggested that this formula violates the plan qualification requirements because you could not have two plans that worked in conjunction to effect the same result. No one would contend that this arrangement should be analyzed as two plans—one plan that provides a 1 percent of pay benefit for all years of service and a second plan with a fifteen year service requirement (in violation of Code § 410(a)(1)).

23. Prop. Treas. Reg. § 1.411(b)-2(b)(2)(iii)(E)(3).

24. Prop. Treas. Reg. § 1.411(b)-2(f)(3).