Do Cash Balance Plans Violate the ADEA?

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The authors examine whether the basic cash balance plan formula violates the rule under Section 411(b)(1)(H) of the Code (as well as its mirror provisions in the ADEA and ERISA) that a participant's rate of benefit accrual in a defined benefit plan may not be reduced because of the attainment of any age. They conclude that the answer is no, when "rate of benefit accrual" is measured as the cost of providing the benefit. The bulk of the article is devoted to showing how the statute and legislative history justify measuring "rate of benefit accrual" for this purpose on a cost basis as well as a benefit basis.

Cash balance plans are an ongoing source of legal and political controversy. In previous issues, we have examined one of the legal questions that arise when a defined benefit plan formula is converted to a cash balance formula ("Cash Balance Plans: Are Wear-Away Transitions Legal Under the ADEA?," 13 *Benefits Law Journal* 1, Spring 2000). We have also, more generally, discussed the strange politics of cash balance plans ("PensionCabal.com—Ruminations on the Cash Balance Crisis," 12 *Benefits Law Journal* 1, Winter 1999).

In this article, we examine one of the most troublesome legal issues surrounding the basic structure of cash balance plans: Does the typical cash balance plan formula violate the rule that "the rate of an employee's benefit accrual" may not be reduced, "because of the attainment of any age" under ERISA, the Internal Revenue Code, and the Age Discrimination in Employment Act (ADEA)?

On the basis of the statute and its legislative history, we conclude that the answer is no.

Because the argument for this position is somewhat complicated, we here provide a brief road map of where we are going.

We first set out the basic rule under Section 411(b)(1)(H) of the Code (and its mirror provisions in ERISA and the ADEA) stating that a

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participant's "rate of benefit accrual" in a defined benefit plan may not be reduced because of age. (We sometimes refer to this as the "rate-of-benefit-accrual rule.") We then show that, for purposes of this rule, the phrase "rate of benefit accrual" may be measured either in terms of the age-65 benefit itself, or as the *cost* of providing this benefit (the "equal cost/equal benefit" rule). As others have observed, in the typical cash balance formula, the rate of growth in the *cost* of the benefit is not reduced with age. To put this another way, cash balance plans satisfy the rate of benefit accrual rule on a *cost* basis, as permitted by the statute.

What is the basis for believing that the rate-of-benefit-accrual rule can be satisfied when measured as the cost of the benefit?

First, policy compels this conclusion. The ADEA, the rule's source, was not intended to require that employers undertake greater costs on behalf of older workers than younger.

But policy is not enough unless supported by the statute. And we do not argue policy here. Our purpose is to show that in enacting the rate-of-benefit-accrual rule, Congress intended that the rule be satisfied either on an *equal cost* or equal benefit basis. Our conclusion follows from the face of the statute, and from ADEA legislative history both before and during enactment of the rate-of-benefit-accrual rule.

In short, a plan may satisfy the rate-of-benefit-accrual rule on an equal cost or equal benefit basis. Cash balance plans satisfy the rule on an equal cost basis, and so meet the demands of law as well as policy.

WHAT IS A CASH BALANCE PLAN?

A cash balance plan is a defined benefit pension plan under Code Section 414(j). That is, participants' benefits are provided without individual accounts and without respect to the actual investment experience of the plan's assets. But the plans are designed to replicate some features of a defined contribution plan: Typically, each participant's benefit is communicated as a notional "account balance" equal to annual allocations, plus earnings credited at a stated rate without regard to service. Distributions of the vested account balance are typically (but not universally) permitted at any time after termination of employment, and may be elected in lump sum form.

The issues in this article are discussed in terms of a hypothetical plan with the following features: Every year, each participant's "account balance" is credited with an amount equal to 5 percent of

compensation, plus hypothetical interest at an annual rate of 6 percent, which in this article we assume is the Code Section 417(e) applicable interest rate. The plan's normal retirement age is 65. We consider two hypothetical employees, O and Y, ages 50 years and 40 years, respectively. Except for age, they are identical for plan purposes: Each has ten years of service, and annual pay of $50,000 that grows at 3 percent per year.

WHY IS AGE DISCRIMINATION AN ISSUE?

Code Section 411(b)(1)(H) was enacted by the Omnibus Budget Reconciliation Act of 1986, Pub. L. 99-509 (1986) (OBRA 1986). It states that a defined benefit plan will not satisfy Section 411 "if under the plan, an employee's benefit accrual ceases or the rate of an employee's benefit accrual is reduced, because of the attainment of any age."

A plan does not fail Section 411(b)(1)(H) merely because it imposes a limit on the amount of benefits or the number of years of service or participation taken into account for determining benefit accrual.[1] Also, a plan does not fail merely because it disregards the early retirement subsidy in determining benefit accruals.[2]

OBRA 1986 also added Section 411(b)(2) of the Code, which provides that for a defined contribution plan, "allocations to an employee's account" may not be ceased or the "rate at which amounts are allocated to the employee's account" reduced because of attainment of any age.

Similar provisions were enacted as Section 4(i)(1)(A) of the ADEA for defined benefit plans, and Section 4(i)(1)(B) of the ADEA for defined contribution plans, and as Section 204(b)(1)(H)(i) of ERISA.

The Problem

The statute prohibits reduction in the "rate of an employee's benefit accrual," because of the "attainment of any age." Why does the typical cash balance formula raise an issue under this rule?

Section 411(a)(7) Accrued Benefit

The issue arises because the meaning of "rate of benefit accrual" is unclear. One possible definition is the rate of growth in the employee's "accrued benefit" as defined under Section 411(a)(7) of the Code. The Section 411(a)(7) accrued benefit is generally defined

as the accrued benefit under the plan, expressed as an annuity commencing at normal retirement age (occasionally herein, the "age-65 annuity").[3] If the benefit commences at an age other than normal retirement age, the Section 411(a)(7) accrued benefit is the *actuarial equivalent* of the normal retirement age benefit.[4]

If "rate of benefit accrual" is defined as the rate of growth in the age-65 annuity (the Section 411(a)(7) accrued benefit), then under certain circumstances, some cash balance plans arguably raise an issue under the rule.

For example, applying this definition to our hypothetical plan, the rate of benefit accrual is arguably reduced because of age. Consider Employee Y. As shown under **Appendix I**, columns 3 through 6, her rate of benefit accrual as so defined is 2.7% at age 40; and declines to 2.0% at age 45, 1.5% at age 50, and 0.6% at age 65.

As another example of applying this definition to our hypothetical plan, compare Employees O and Y. After 5 years, each has identical years of service (15), compensation ($57,964), contributions ($2,898), and notional account balances ($18,706). But if expressed in terms of the age-65 annuity, their rate of benefit accrual is different. For Y (now age 45), the rate of accrual is 2.0%; for O (now age 55), 1.1%. (See Appendix I, columns 3 through 6.) The lesser rate of accrual for O comes about *only* because of O's greater age; in all other pertinent respects, O and Y are the same.

This result comes about because of the time value of money. When expressed as an age-65 benefit, an increment to the account balance of an older employee is less valuable than that of a younger employee, all else being equal. To put this another way, in comparison with Y's benefit, each increment of O's benefit has fewer years to grow between the year of allocation and O's attainment of age 65, and so is less valuable when expressed as the age-65 benefit.

It is also important to remember that the result depends on the assumptions used in our hypothetical plan. Under other assumptions about wage growth or contribution rates, the numbers would be different. For example, consider our hypothetical plan using the slightly modified assumptions of Appendix I, Columns 7 through 10. Here the initial contribution rate is 6% and grows as a percentage of compensation at a rate of 6% thereafter. (In some cash balance plans, the rate of contribution increases as a percentage of compensation.) In this modified scenario, there is no decline in the rate of the age-65 annuity.

In short, some have assumed that "rate of benefit accrual" under Sections 411(b)(1)(H) of the Code and 4(i) of the ADEA means rate

of growth in the age-65 annuity (the Section 411(a)(7) accrued benefit). Under this assumption (and using additional assumptions concerning, for example, wage growth and earnings and contribution rates), some have concluded that the "rate of benefit accrual" in a cash balance plan is reduced because of age, in violation of law.

"RATE OF BENEFIT ACCRUAL" DOES NOT MEAN RATE OF INCREASE IN THE AGE-65 ANNUITY

As we have shown, cash balance plans raise issues under the rate of benefit accrual rule if it is assumed that "rate of benefit accrual" means rate of growth in the Section 411(a)(7) accrued benefit (the age-65 annuity). But is this underlying assumption correct?

No, it is wrong. The "rate of benefit accrual" in Section 411(b)(1)(H) *cannot* mean rate of the Section 411(a)(7) accrued benefit. This is apparent on the face of the statute, as we show here.

Section 411(b)(1)(B)

The "anti-back-loading rule" of Code Section 411(b)(1)(B) caps the allowable rate of increase in the Section 411(a)(7) accrued benefit. The anti-back-loading rule is stated in terms of the "annual rate" at which the participant can "accrue the retirement benefits *payable at normal retirement age.*" That is, where Congress intended to identify "rate of accrual" as the increase in the age-65 benefit, the statute states this identity expressly.

When Congress includes limitations in one subsection of a statute, but not another, we are required to conclude that the limiting language was not intended to apply to the subsection where omitted.[5] We must therefore infer that "rate of accrual" in Section 411(b)(1)(H), without the qualifying "benefits payable at normal retirement age," is intended to mean something different.

Early Retirement Subsidy

Second, subparagraph (v) of Section 411(b)(1)(H) states that the rate-of-benefit-accrual rule is not violated merely because any *early retirement subsidy* is disregarded in determining benefit accruals. But the early retirement subsidy is *not* part of the Section 411(a)(7) accrued benefit. This is apparent on the face of the statute, which, as noted, defines the accrued benefit commencing before normal retirement age as the *actuarial equivalent* of the normal retirement age

benefit.[6] That is, by definition, the early retirement subsidy is the *increment in excess of* the Section 411(a)(7) accrued benefit.

The Code is consistent in defining the accrued benefit as the benefit without the early retirement subsidy.[7] Treasury regulations state that the early retirement subsidy is not part of the accrued benefit.[8] ERISA legislative history shows that Congress intended that the accrued benefit not include the early retirement subsidy.[9] And majority case law is in accord that the accrued benefit does not include the early retirement subsidy.[10]

In short, the early retirement subsidy is not part of the Section 411(a)(7) accrued benefit, yet subparagraph (v) of Section 411(b)(1)(H) contains an express exception to the rate-of-benefit-accrual rule for the early retirement subsidy. Were "rate of accrual" in Section 411(b)(1)(H) intended to denote the rate of growth of the Section 411(a)(7) accrued benefit, the exception of subparagraph (v) would be unnecessary and meaningless — because, even without this exception, the early retirement subsidy would not affect the rate of change in the Section 411(a)(7) accrued benefit. It must be inferred that Congress intended "rate of accrual" to mean something different.[11]

Post-Age-65 Offset Rule

The rate-of-benefit-accrual rule contains a number of statutory exceptions for benefit accruals after normal retirement age. One of these exceptions provides that "any requirement of this subparagraph for *continued accrual of benefits* under such plan" may be offset by the statute's required actuarial increase for benefits payable after normal retirement age.[12]

But, as noted, under Code Section 411(c)(3), the statutory definition of the Section 411(a)(7) accrued benefit commencing after normal retirement age is the *actuarial equivalent* of the normal retirement age benefit. That is, if provided as an annual add-on to the Section 411(a)(7) accrued benefit, each year's "continued accrual" after normal retirement age must by definition include not only the plan's stated "accrual," but also the actuarial bump-up of that incremental "accrual"—plus, presumably, of the previously accrued benefit—necessary to satisfy Section 411(c)(3).

But to read "continued accrual" in this way—as the increment in the Section 411(a)(7) accrued benefit—would nullify the offset rule. It thus cannot be correct under the standard principles of statutory

construction already cited. Moreover, proposed Treasury regulations have not so interpreted the offset rule. Rather, in their example of the offset rule, proposed regulations interpret the "continued accrual" to mean benefit increments under the plan's stated formula, rather than an increase in the Section 411(a)(7) accrued benefit.[13]

To summarize: Under the structure of the statute, "rate of accrual" in Section 411(b)(1)(H) and ADEA Section 4(i) does not mean rate of increase in the Section 411(a)(7) accrued benefit.

"RATE OF BENEFIT ACCRUAL" RULE CAN BE MET ON EQUAL COST OR EQUAL BENEFIT BASIS

If the ADEA rate-of-benefit-accrual rule does not mean the rate of growth in the Section 411(a)(7) accrued benefit, what does it mean?

We believe that statute and its legislative history point to one conclusion: The rate-of-benefit-accrual rule requires that the growth in benefits not decline with age, when measured either as the amount of benefit or *as the employer's cost of providing the benefit.*

There are many policy reasons for this conclusion:

- *Annual lump sum cost.* The annual contribution, disregarding future interest, as a percent of pay is the same for all participants regardless of age. Requiring more for older employees would compel a subsidy on the basis of age, which the ADEA does not intend.
- *Years to payout.* The annual contribution plus interest at the stated rate, as a percent of pay, is the same for all participants regardless of age, when measured over the same number of years between date of initial contribution and date of payout. Measuring these amounts on the basis of their age-65 value assumes a fixed age of payout, which the ADEA does not require.
- *403(b) annuities.* In a common retirement arrangement for school employees, the employer contributes an amount based on compensation and years of service. The contribution purchases an annuity payable at age 65. That is, these contributions look a lot like cash balance plans. For any two employees with the same service and compensation, the contribution is the same, but the age-65 annuity is smaller for the older than the younger. Yet these plans do not violate Sections 4(i) of the ADEA or 411(b)(1)(H) of the

Code. It is not equitable—and the ADEA does not intend—that two almost identical plans be treated differently under the law because of differences in their funding arrangements.

- *Equal treatment with similar-looking defined contribution plans.* A cash balance plan is designed to look like a defined contribution plan, at least before normal retirement age. For a defined contribution plan, the ADEA and the Code require that *allocations* may not be reduced because of age. This rule is satisfied on an equal cost basis. It is not equitable—and the ADEA does not intend—that plans with similar benefit structures be treated differently merely because of their technical classification under the Code.
- *Other discrimination statutes.* In measuring "discrimination" between benefits earned by high paid and low paid employees under a qualified defined benefit plan, Treasury regulations allow testing on a cost or benefit basis. Treasury has already decided that discrimination is appropriately measured by the burden on the employer.

These arguments are fair and reasonable from a policy perspective. In an ERISA world where employee benefits are provided at the employer's option, an employer could just as easily establish a defined contribution plan. The defined contribution plan satisfies the ADEA and Code Section 411(b)(2) on an equal cost basis. Why would Congress have intended to impose a greater cost burden on employers that undertake to provide a defined benefit plan?

But putting policy aside, as a purely technical matter, these arguments all rise or fall together, because they are all the same argument. They all say that when "accrual" is measured as *annual cost* under the plan, rather than as the discounted value of the age-65 benefit, the rate of accrual in the typical cash balance plan does not decline with age.

Here we discuss how legislative history shows that Congress intended just this result.

ADEA Before OBRA 1986: Equal Cost/Equal Benefit

Before OBRA 1986, the ADEA governed pension plans under Sections 4(a) and 4(f)(2). Section 4(a) stated that it was unlawful to

discriminate against any individual with respect to compensation or terms, conditions or privileges of employment because of age. Section 4(f)(2) provided an exception for, among other things, a pension plan that was not a "subterfuge" to evade the purposes of the Act.

The Department of Labor interpreted Section 4(f)(2) and its legislative history to provide that a benefit plan would be in compliance where the amount of benefit payout, *or the cost* of the benefit, was the same for an older worker as a younger (the equal cost/equal benefit rule).

> A [retirement or pension plan] will be considered in compliance with the statute where the actual amount of payment made *or cost incurred* on behalf of an older worker is equal to that made or incurred on behalf of a younger worker *even though the older worker may thereby receive a lesser amount* of pension or retirement benefits.[14]

These regulations applied to pension plans generally, but contained explicit exceptions for post-age-65 benefits and contributions. For example, for participants who had reached normal retirement age, defined benefit plans could cease crediting service for benefit accrual purposes, decline to provide actuarial increases for delayed payout stemming from delayed retirement, and ignore salary increases and benefit enhancements under the plan; defined contribution plans could cease continued contributions.[15]

In 1985 the Equal Employment Opportunity Commission (EEOC) acquired jurisdiction of the ADEA. The EEOC proposed to retain the Labor Department's equal cost/equal benefit rule for pensions generally.

In addition, the EEOC Commissioners voted to repeal the Labor Department's regulatory carve-outs for post-age-65 benefits. The Commissioners reasoned that these exceptions were not in compliance with the statute. In so doing, the EEOC expressly stated that post-age-65 benefits could satisfy ADEA on the basis of *equal costs or equal benefits*:

> The Commission therefore proposes to modify the existing interpretation to reflect the principle that a retirement pension or insurance plan will be considered in compliance with the statute where the actual amount of payment made or cost incurred in behalf of an older worker is equal to that made or incurred in behalf of a younger worker *even though the older worker thereby may receive a lesser amount of pension or retirement benefits or insurance coverage.*[16]

Other Sources of Equal Cost/Equal Benefit Rule

The equal cost/equal benefit rule was well established in 1986. The rule was first set forth in 1970 Labor Department regulations, and reissued in the 1979 regulations discussed above. The rule was clearly set forth in 1978 legislative history of the ADEA.[17] The rule was articulated again in legislative history to the 1978 amendments to ADEA. In addition, case law accepted that the equal cost/equal benefit rule applied to benefit plans.[18]

These many sources of the equal cost/equal benefit rule are authoritatively laid out in legislative history of the 1990 amendments to the ADEA, the Older Workers Benefit Protection Act (OWBPA).[19] The 1990 legislative history is particularly significant as evidence that, only four years later, the drafters of the 1986 amendments believed that (1) Section 4(f)(2) embodied an equal cost/equal benefit rule, and (2) that this rule was apparent from the Act's inception.

The intent of the 1990 OWBPA amendments was to repudiate the Supreme Court's decision in *Public Employees Retirement System of Ohio v. Betts*, 492 U.S. 158 (1989), in which the Court held that the equal cost rule is not an exclusive defense to the equal benefit rule under ADEA Section 4(f)(2). The conferees wrote that, in rejecting the equal cost/equal benefit rule, the Court "rejected the wealth of legislative history regarding the limited purpose behind Section 4(f)(2), the contemporaneous and long-standing interpretations of the Executive Branch and the unanimous opinions of the courts of appeal."[20]

OBRA 1986

To summarize the state of play in 1986: Under regulations, an equal cost/equal benefit rule applied to pensions generally. The only exceptions to the rule were those carve-outs expressly laid out in regulations for benefits earned after normal retirement age. For benefits accruing before normal retirement age, and other benefits not covered by the regulatory exceptions, the equal cost/equal benefit rule applied. In 1985, the EEOC voted to upset this balance by repealing the exceptions for post-age-65 benefit accruals and contributions. Otherwise, the EEOC expressly proposed to leave the equal cost/equal benefit rule untouched.

In OBRA 1986, Congress enacted the rate-of-benefit-accrual rule. As their "reasons for change," the conferees state the EEOC's pending 1985 unpublished proposed regulation. The conferees note that

the EEOC would require employers to continue accruals and allocations *after* normal retirement age, and conclude that "Disagreement exists as to whether and to what extent benefit accruals and allocations are required under ADEA, as currently in effect."[21] The EEOC's 1985 vote was apparently the catalyst for congressional action. In the face of disagreement about the equal cost/equal benefit rule as applied to post-age-65 accruals, Congress sought to legislate certainty.

On a prospective basis, OBRA 1986 made Section 4(i) the exclusive ADEA rule governing the rate of pension accruals and contributions, supplanting application of ADEA Sections 4(a) and (f).[22] Congress also expressed its intent that the rate-of-benefit-accrual rule as expressed in the Code, ERISA, and the ADEA have the same meaning for all three statutes, and directed the three responsible agencies to promulgate consistent rules.[23]

In enacting the rate-of-benefit-accrual rule, what did Congress intend? We have seen that they did not mean to prohibit a decline in the rate of the Section 411(a)(7) accrued benefit. What they did mean is that the growth of pension benefits cannot decline when measured *on a benefit or cost basis*. Legislative history points to this conclusion: the equal cost/equal benefit rule is what Congress understood the rule to be, the rule they understood already applied to accruals generally, and the rule they thought needed clarifying only for post-age-65 accruals.

For example, in his floor statement Congressman Jeffords states that benefit plans are permitted to satisfy the rate of benefit accrual rule on an equal cost basis.

> The legislation makes clear that factors other than age—such as *plan cost*, years of service or participation, nondiscrimination requirements for the highly compensated . . . [etc.]—are either allowed or required to be taken into account in a fashion which may reduce or eliminate post-normal retirement age accruals.[24]

Other evidence in legislative history points the same way. In their "reasons for change," the conferees state that EEOC sought to "require employers to *continue benefit accruals* and allocations."[25] As noted, the EEOC sought only to apply the already extant equal cost/equal benefit rule to post-age-65 accruals. The conferees evidently identified "continued" benefit accruals with continued accruals measured as equal benefits or costs. In setting forth the new rule, the conferees nowhere state that "continued benefit accruals" has changed in meaning from the EEOC's definition (equal cost/equal benefit), to one requiring an equal age-65 annuity.[26]

Moreover, it should be recalled that in 1986, the equal cost/equal benefit rule was apparent in every other source of ADEA law. The rule was exhaustively discussed during the ADEA's enactment in 1969 and amendment in 1978, was embodied (with exceptions for pension plans) in two rounds of Department of Labor regulations, was reaffirmed by the EEOC in 1985, and had been endorsed in case law. To repeal this principle would overturn a major rule, of long standing, endorsed and accepted by everyone. Repeal would introduce two concepts totally new to the ADEA: defined benefit plans are required by law to shoulder rising costs for aging employees, and these plans must take on a relatively *greater* burden than defined contribution plans. Nowhere do the conferees give the smallest hint they thought they might be undertaking such a radical revision of the law as then widely understood.

Not only were the conferees aware of the equal cost/equal benefit rule; legislative history consistently shows that conferees assumed that *this same rule already applied to benefits earned before normal retirement age,* and did not require alteration for these benefits. For example, in her floor statement Congresswoman Roukema states that:

> The conference report . . . makes clear that with respect to benefit accruals under normal retirement age, pension plans which conform with the *existing benefit accrual rules* under ERISA and the Internal Revenue Code are considered to meet the new requirements. This framework provides a safe harbor for pre-normal retirement age accruals for all covered pension plans. . . .[27]

Congressman Jeffords expressed a similar thought: For pre-normal retirement age accruals, the new rules leave current law untouched:

> In this coordinated fashion, the amendments also make it clear that pension benefit accruals prior to normal retirement age meet the age nondiscrimination provision if they also conform to the benefit accrual rules described in section 204 of ERISA and section 411(b) of the Internal Revenue Code.[28]

The conference committee report similarly states that, for pre-age-65 accruals, "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." In other words, for pre-age-65 accruals, currently understood or "normal" rules continue to apply.

This reading of congressional intent clears up another puzzle. The rate-of-benefit-accrual rule applies on its face to all accruals. But the conferees discuss the new law only in terms of post-normal retirement age benefits. This makes sense if the conferees understood that ADEA *already* applied as a general matter, and believed they were merely modifying the rules for accruals *after* normal retirement age.

As an example: the conferees' only stated "reason for change" of prior law is the EEOC's vote to repeal the Labor Department's carve-out for post-age-65 benefits. The conferees do not discuss the rules the EEOC would have left untouched—because, like the EEOC, they did not intend to change those rules.

As another example, one can look to the floor statement of Congressman Clay. He expresses concern about constituents who have complained that they were "unfairly denied pension credit when they *continue to work past normal retirement age*." He concludes that the new OBRA 1986 rules are needed because "Genuine disagreement exists as to whether under current law *additional* pension accruals or allocations are required."[29] In Congressman Clay's understanding, that is, the new rules apply only to those "additional" benefits earned by those who work past normal retirement age.

The conferees' assumption also explains the otherwise confusing subheading under Code Section 411(b)(1)(H). The paragraph is entitled "Continued accruals beyond normal retirement age." Some have argued this subheading means that paragraph (H) applies only to post-normal retirement age benefits. This argument cannot be right, however, as Section 411(b)(1)(H) on its face applies to accruals *before* normal retirement age as well. Legislative history would appear to clear up this minor puzzle. The conferees merely intended to flag their intention to apply current law, with statutory carve-outs, to accruals after normal retirement age.

In short, the conferees meant only to continue pre-1986 law with respect to accruals generally, and modify the law with respect to post-age-65 accruals by setting forth acceptable and unacceptable carve-outs.

Equal-Cost Rule Embraces Varying Growth of "Accrued Benefit" Based on Age at Hire

We have seen that Congress apparently meant the rate-of-benefit-accrual rule to be satisfied on an equal cost or equal benefit basis. There is also some evidence that the conferees specifically

understood one of the implications of this rule: under some formulas, the rate of growth in the Section 411(a)(7) accrued benefit may vary only because of age at the date of hire.

Specifically, the conference committee report states that under "normal" benefit accrual rules, the rate of accrual 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."[30] That is, the report apparently blesses the accrual pattern of our hypothetical cash balance plan.

OWBPA

In 1990, Congress amended Section 4(f) of the ADEA to clarify the application of the equal cost/equal benefit rule to employee benefit plans. As revised by the OWBPA, Section 4(f)(2) of the ADEA provides that in a bona fide benefit plan, the "actual amount or payment made or cost incurred on behalf of an older worker" must be no less than that "made or incurred on behalf of a younger worker," as permitted under EEOC regulations, 29 C.F.R. Section 1625.10, in effect on June 22, 1989.

The OWBPA did not amend ADEA Section 4(i) or Code Section 411(b)(1)(H), and in legislative history the conferees stated that no alteration or modification of Section 4(i) was intended.[31] To the extent that Section 4(i) does not apply, however, the OWBPA's structure and legislative history provide that ADEA Sections 4(a) and (f), as amended by that statute, apply to pension plans.[32]

Case Law

The Seventh Circuit has recently stated the equal cost/equal benefit rule of ADEA Sections 4(a) and 4(f) applies to accruals in a defined benefit plan, in *Quinones v. City of Evanston*, 58 F.3d 275 (7th Cir. 1995).

In *Quinones*, the court (per Judge Easterbrook) examined a hypothetical defined benefit plan with a 2-percent-per-year-of-service final average pay formula. In dictum, the court states that under ADEA Section 4(f)(2) a defined benefit plan may reduce the rate of benefit growth for older employees so that the *annual cost per year* is the same for all workers.

The court's reasons for concluding that a defined benefit plan can satisfy the ADEA on an equal cost basis are the very policy and legal considerations we have advanced here: an equal cost rule is

permitted for defined contribution plans "and it would make no sense to say that an equivalent adjustment to a defined benefit plan violates the Act."[33] Second, the court notes that EEOC regulations (at 29 C.F.R. 1625.10(a)(1)) allow employers to reduce benefits for workers who begin services at older ages to the extent necessary to achieve equal cost for older and younger workers.

The court's reasoning is given under Sections 4(a) and 4(f)(2) of the ADEA. But as the same principles were imported into Section 4(i), the reasoning should apply to that section as well.

ADDITIONAL ISSUES

We here deal with possible issues that might arise under our analysis, and conclude they do not pose problems.

Enactment of New Section

If Congress intended to continue current law except for post-age-65 accruals, why did it enact new section ADEA Section 4(i)? Why didn't Congress instead amend Sections 4(a) and (f)(2)?

Because of the intervening passage of ERISA. The Labor Department's equal cost/equal benefit rule as promulgated in 1970 allowed plans to reduce the stated amount of benefits under a plan if necessary to achieve equal costs (for example, in disability benefit plans). But ERISA, enacted in 1974, prohibits reduction of a participant's age-65 annuity.[34]

In enacting the rate-of-benefit-accrual rule, Congress shaped the equal benefit/equal cost principle to fit ERISA's new requirements. Under the rate-of-benefit-accrual rule, and in compliance with ERISA, an employer cannot reduce the total amount of a participant's age-65 benefit, even if necessary to achieve equal cost. But the employer can reduce or even halt the rate of growth in the cost of the benefit, on an annual basis. By couching the rule in terms of benefit "accrual," Congress provided that, in compliance with an ERISA-fied world, equal cost must be measured on the basis of yearly increments.

Statutory Structure

Sections 411(b)(1)(H) of the Code and 4(i) of the ADEA expressly distinguish between defined benefit and defined contribution plans. They require nondecreasing "accruals" for the former, and

"allocations" for the latter. If Congress had intended the same rule for both, wouldn't they have used the same terms?

We believe the better answer is no. The distinction between "accruals" and "allocations" in the statute most obviously reflects the separate account nature of defined contribution plans, versus the non-account nature of defined benefit plans. It does not also imply a distinction between an equal cost rule for defined contribution plans, and an equal benefit rule for defined benefit plans.

We have already seen that rate of "accrual" cannot mean rate of growth in the Section 411(a)(7) accrued benefit. Lots of other examples show that the statute uses the words "accrual," "contribution," and "benefit" loosely and interchangeably. For example, ADEA Section 4(i)(4) states that compliance with Section 4(i) constitutes compliance with all of ADEA Section 4 "relating to benefit *accrual*" under a benefit plan [emphasis supplied]. But the Conference Committee report states that Congress intended that this rule apply both to *accruals and contributions* under defined benefit and defined contribution plans:

> It is the intention of the conferees . . . that the requirements contained in section 4(i) relating to an employee's right to benefit accruals with respect to an employee benefit plan (as defined in section 3(2) of ERISA) shall constitute the entire extent to which ADEA affects such benefit *accrual and contribution matters* with respect to such plans on or after the effective date of such provisions. . . No inference is to be drawn by the addition of section 4(i) as to when or to what extent employee benefit plans might have been required to provide benefit *accruals or allocations* to employees' accounts for employees protected under ADEA prior to the effective date of section 4(i).[35]

To consider a second example: Section 4(i) of the ADEA states that it is not violated merely because the plan caps the "amount of benefits" or years of service taken into account for determining "benefit accrual under the plan." Section 411(b)(1)(H)(ii) contains an almost identically worded exception.

Both rules are expressed as caps on the "amount of benefits" or service for determining "benefit accrual." Yet legislative history and agency guidance take the position that the rules also permit caps on employer *contributions*, and years of service for making such *contributions*:

> Under the conference agreement, benefit accruals or continued allocations to an employee's account under either a defined benefit

> plan or a defined contribution plan may not be reduced or discontinued on account of the attainment of a specified age. A plan may impose a limitation on the amount of benefits provided under the plan or a limitation on the number of years of service or plan participation taken into account. The conferees intend that a plan should not be treated as violating the general rule merely because the plan limits benefits to a stated dollar amount or a stated percentage of compensation.[36]

In proposed regulations, the Treasury Department and EEOC have likewise taken the position that under the "amount of benefit" rule, defined *contribution* plans may limit the amount of employer *contributions*; under the service-for-benefit-accrual rule, a defined *contribution* plan may limit the total number of years of service for determining a participant's allocated *contributions and forfeitures*.[37]

Thus, in the phrase "amount of benefit," in this context Congress apparently meant to include amount of *contribution*; and in specifying years of benefit *accrual*, Congress meant to include benefit contributions. On the basis of legislative history and contemporaneous regulatory interpretation, we must conclude that Congress meant to use "accrual" and "rate of accrual" to denote costs and contributions as well.

CONCLUSION

We have here sought to show that cash balance plans satisfy the rate-of-benefit-accrual rule of Sections 411(b)(1)(H) of the Code, 4(i) of the ADEA, and 204(b)(1)(H) of ERISA.

We observe that they satisfy the rule when measured on the basis of the employer's *cost* of providing the benefit. We have shown Congress intended just this result: defined benefit plans are permitted to satisfy the rule on an equal cost or equal benefit basis.

Our arguments for this can be summarized simply. The equal cost rule was the ADEA rule from the beginning. As of 1986, everybody knew it. Every actor responsible for developing ADEA law and policy endorsed it: lawmakers, regulators, courts. Legislative history gives not the slightest hint that Congress thought it was overturning this long-standing widely-held principle, without discussion, without hearings, without debate, without explanation, to enact a principle entirely new in the ADEA realm: defined benefit plans must undertake ever-increasing costs on behalf of older workers, and must be increasingly burdened relative to defined contribution plans.

To the contrary, every shred of legislative history shows that Congress thought that it was merely extending a long-standing

principle of law, conforming it to a new, post-ERISA world, and allowing defined benefit plans to provide equal benefits to older employees when measured as the incremental annual cost of providing the benefit.

NOTES

1. I.R.C. §411(b)(1)(H)(ii).

2. I.R.C. §411(b)(1)(H)(v).

3. I.R.C. §411(a)(7)(A)(i).

4. I.R.C. §411(c)(3).

5. *Rusello v. United States*, 464 U.S. 16, 23 (1983), and cases cited therein.

6. I.R.C. §411(c)(3).

7. See, e.g., I.R.C. §411(d)(6)(B)(i) (for purposes of anti-cutback rule, early retirement subsidy treated "as if" it were accrued benefit).

8. Treas. Reg. §1.411(a)-7(a)(1)(flush language) ("For purposes of this subparagraph [defining "accrued benefit"] a subsidized early retirement benefit which is provided by a plan is not taken into account, except to the extent of determining the normal retirement benefit under the plan.").

9. H. Rep. No. 779, 93d Cong. 2d Sess. 59 (Feb. 1974); H. Rep. No. 1280, 93d Cong. 2d Sess. 273 (Aug. 1974) ("Also, the accrued benefit does not include the value of the right to receive early retirement benefits, or the value of social security supplements or other benefits under the plan which are not continued for any employee after he has attained normal retirement age.").

10. *Atkins v. Northwest Airlines, Inc.*, 967 F.2d 1197, 1201 (8th Cir. 1998); *De Nobel v. Vitro Corp.*, 885 F.2d 1180, 1194 (4th Cir. 1989); *American Stores Co. v. American Stores Co. Retirement Plan*, 928 F.2d 986, 990 (10th Cir. 1991); *Ashenbaugh v. Crucible, Inc., 1975 Salaried Retirement Plan*, 854 F.2d 1516 (3d Cir. 1988), cert. denied, 490 U.S. 1105 (1989); *Bencivenga v. Western Pennsylvania Teamsters and Employers Pension Fund*, 763 F.2d 574 (3d Cir. 1985); *Tilly v. Mead Corp.*, 927 F.2d 756 (4th Cir. 1991). See *McBarron v. S&T Indus., Inc.*, 771 F.2d 94 (6th Cir. 1985). Contra *Amato v. Western Union Int'l, Inc.*, 773 F.2d 1402 (2d Cir. 1985), cert. dismissed, 474 U.S. 1113 (1986).

11. See, e.g., *Vetco, Inc. v. Comm'r*, 95 T.C. 579 (1990).

12. I.R.C. §411(b)(1)(H)(iii).

13. Prop. Treas. Reg. §1.411(b)-2(b)(3)(iv), Example (2).

14. 29 CFR §860.120(a) (1979) [emphasis supplied].

15. 29 CFR §860.120(f)(1)(iv) (1979).

16. EEOC Proposed Partial Rescission of Interpretive Bulletin, *reprinted at* 12 *BNA Pension Reporter* 389 (Mar. 11, 1985) (occasionally referred to herein as the "1985 unpublished proposed rule").

17. See, e.g., floor remarks of Senator Javits, 113 Cong. Rec. 31254-55 ("[Under section 4(f)(2)], an employer will not be compelled to afford older workers exactly the same

pension retirement or insurance benefits as younger workers and thus employers will not because of the often extremely high cost of providing certain types of benefits to older workers, and actually be discouraged from hiring older workers.").

18. See, e.g., *EEOC v. Westinghouse Elec. Corp.*, 725 F.2d 211 (3d Cir. 1983), cert. denied, 486 U.S. 820 (1984); *EEOC v. Borden's Inc.*, 724 F.2d 1390 (9th Cir. 1984).

19. See S. Rep. No. 263, 101st Cong., 2d Sess. 6-13 (1990) (the "1990 Committee Report").

20. Id. at 18.

21. H. Conf. Rep. No. 112, 99th Cong., 2d Sess. 378 (1986) (the "1986 Conference Report").

22. ADEA §4(i)(4) ("compliance with the requirements of this subsection with respect to an employee pension benefit plan shall constitute compliance with the requirements of this section relating to benefit accrual under such plan"); see also 1986 Conference Report at 382 (the 4(i) rules "related to an employee's right to benefit accruals with respect to an employee benefit plan...shall constitute the entire extent to which ADEA affects such benefit accrual and contributions matters on or after the effective date").

23. See 1986 Conference Report at 378-9 (conferees do not intend to create an inference that a difference exists among provisions in three statutes); 1986 Conference Report at 382 (Treasury, Labor, and EEOC to issue "rulings and regulations that are consistent"); Statement of Congressman Jeffords, 132 Cong. Rec. H 11437 (Oct. 17, 1986).

24. 132 Cong. Rec. H 11437 (Oct. 17, 1986) [emphasis supplied].

25. 1986 Conference Report at 378.

26. See, e.g., 1986 Conference Report at 378 ("Under the conference agreement, benefit accruals or continued allocations to an employee's account under either a defined benefit plan or a defined contribution plan may not be reduced or discontinued on account of the attainment of a specified age.").

27. Statement of Cong. Roukema, 132 Cong. Rec. H 11437 (Oct. 17, 1986).

28. Statement of Cong. Jeffords, 132 Cong. Rec. H 11437 (Oct. 17, 1986).

29. Statement of Congressman Clay, 132 Cong. Rec. H. 11437 (Oct. 17, 1986) [emphasis supplied].

30. 1986 Conference Report at 379.

31. 1990 Committee Report at 19-20.

32. ADEA §4(*l*); 1990 Committee Report 19-23.

33. 58 F.3d at 279.

34. I.R.C. §411(d)(6); ERISA §204(g).

35. 1986 Conference Report at 382 [emphasis supplied].

36. Id. at 378.

37. Prop. Treas. Reg. §1.411(b)-2(c)(2); Prop. 29 C.F.R. §1625.21(f)(i) and (ii).

Appendix 1. Cash Balance Plan Examples

Employee Y: Growth in cash balance "account"

Column 1	Column 2	Column 3	Column 4	Column 5	Column 6	Column 7	Column 8	Column 9	Column 10
Age	Compensation (assume 3% annual pay increase)	Contribution I (equals 5% of comp.)	"Account balance" at the end of the year	Age-65 Annuity	"Rate of Accrual I" (increment in age-65 annuity as percent of comp.)	Contribution II (6% of comp. in 1st year, percentage grows thereafter at 6% rate)	"Account balance" at the end of the year Contribution II	Age-65 Annuity assuming Contribution II	"Rate of Accrual II" (increment in age-65 annuity as percent of comp., assuming Contribution II)
40	50,000	2,500	2,500	1,341	2.7%	3,000	3,000	1,609	3.2%
41	51,500	2,575	5,225	2,644	2.5%	3,275	6,455	3,267	3.2%
42	53,045	2,652	8,191	3,911	2.4%	3,576	10,419	4,975	3.2%
43	54,636	2,732	11,414	5,141	2.3%	3,904	14,948	6,733	3.2%
44	56,275	2,814	14,913	6,337	2.1%	4,263	20,108	8,545	3.2%
45	57,964	2,898	18,706	7,499	2.0%	4,654	25,969	10.411	3.2%
46	59,703	2,985	22,813	8,628	1.9%	5,081	32,608	12,332	3.2%
47	61,494	3,075	27,256	9,725	1.8%	5,548	40,112	14.312	3.2%
48	63,339	3,167	32,059	10.791	1.7%	6.057	48,576	16,351	3.2%
49	65,239	3,262	37,244	11,827	1.6%	6,613	58,104	18,451	3.2%
50	67,196	3,360	42,839	12,833	1.5%	7,220	68,810	20,614	3.2%
51	69,212	3,461	48,870	13,811	1.4%	7,883	80,822	22,841	3.2%

52	71,288	3,564	55,366	14,762	1.3%	8,607	94,278	25,136	3.2%
53	73,427	3,671	62,360	15,685	1.3%	9,397	109,332	27,500	3.2%
54	75,629	3,781	69,883	16,582	1.2%	10,259	126,151	29,934	3.2%
55	77,898	3,895	77,970	17,454	1.1%	11,201	144,921	32,442	3.2%
56	80,235	4,012	86,660	18,301	1.1%	12,230	165,846	35,024	3.2%
57	82,642	4,132	95,992	19,125	1.0%	13,352	189,149	37,684	3.2%
58	85,122	4,256	106,008	19,925	0.9%	14,578	215,076	40,424	3.2%
59	87,675	4,384	116,752	20,702	0.9%	15,916	243,897	43,247	3.2%
60	90,306	4,515	128,272	21,457	0.8%	17,377	275,908	46,153	3.2%
61	93,015	4,651	140,620	22,191	0.8%	18,973	311,435	49,147	3.2%
62	95,805	4,790	153,847	22,904	0.7%	20,714	350,836	52,231	3.2%
63	98,679	4,934	168,012	23,597	0.7%	22,616	394,501	55,408	3.2%
64	101,640	5,082	183,174	24,271	0.7%	24,692	442,864	58,679	3.2%
65	104,689	5,234	199,399	24,925	0.6%	26,959	496,394	62,049	3.2%

Assumptions: Rate of interest = 6% (equals Code section 417 "applicable interest rate"); annuity factor at age 65 = 8.

Employee O: Growth in cash balance "account"

Column 1	Column 2	Column 3	Column 4	Column 5	Column 6	Column 7	Column 8	Column 9	Column 10
Age	Compensation (assume 3% annual pay increase)	Contribution I (5% of comp.)	"Account balance" at the end of the year	Age-65 Annuity	"Rate of Accrual I" (increment in age-65 annuity as percent of comp.)	Contribution II (6% of comp. in 1st year, percentage grows thereafter at 6% rate)	"Account balance" at the end of the year assuming Contribution II	Age-65 Annuity assuming Contribution II	"Rate of Accrual II" (increment in age-65 annuity as percent of comp., assuming Contribution II)
50	50,000	2,500	2,500	749	1.5%	5,373	5,373	1,609	3.2%
51	51,500	2,575	5,225	1,477	1.4%	5,866	11,561	3,267	3.2%
52	53,045	2,652	8,191	2,184	1.3%	6,404	18,658	4,975	3.2%
53	54,636	2,732	11,414	2,871	1.3%	6,992	26,770	6,733	3.2%
54	56,275	2,814	14,913	3,539	1.2%	7,634	36,010	8,545	3.2%
55	57,964	2,898	18,706	4,187	1.1%	8,335	46,506	10,411	3.2%
56	59,703	2,985	22,813	4,818	1.1%	9,100	58,396	12,332	3.2%
57	61,494	3,075	27,256	5,430	1.0%	9,935	71,835	14,312	3.2%
58	63,339	3,167	32,059	6,026	0.9%	10,847	86,993	16,351	3.2%
59	65,239	3,262	37,244	6,604	0.9%	11,843	104,055	18,451	3.2%
60	67,196	3,360	42,839	7,166	0.8%	12,930	123,229	20,614	3.2%
61	69,212	3,461	48,870	7,712	0.8%	14,117	144,740	22,841	3.2%
62	71,288	3,564	55,366	8,243	0.7%	15,413	168,838	25,136	3.2%
63	73,427	3,671	62,360	8,758	0.7%	16,828	195,796	27,500	3.2%
64	75,629	3,781	69,883	9,259	0.7%	18,373	225,917	29,934	3.2%
65	77,898	3,895	77,970	9,746	0.6%	20,060	259,532	32,442	3.2%

Assumptions: Rate of interest = 6% (equals Code section 417 "applicable interest rate"); annuity factor at age 65 = 8.