Fall 2001

Perspective - A Controversy Over Age in an Age of Cash Balance Controversy

Norman Stein

Perspective—
A Controversy Over Age in an Age of Cash Balance Controversy

Norman Stein

Cash balance plans have moved from the media spotlight into the deliberative focus of the judiciary. Two appellate decisions last year refused to give cash balance plans a judicial pass from ERISA's cash-out and backloading rules, which in combination can require lump sum distributions in excess of a participant's hypothetical account balance. And now cash balance plans face a new and more significant round of judicial challenges, this one involving their one potentially lethal legal (as opposed to political and policy) shortcoming: their failure to satisfy the age-based accrual requirement of IRC Section 411(b)(1)(H).

Section 411(b)(1)(H), and parallel provisions in both Title I of ERISA and the ADEA, make it unlawful for a defined benefit plan to reduce a participant's rate of accrual on account of age. Virtually all cash balance plans flunk this test if the annual benefit accrual is an annuity commencing at normal retirement age; virtually all cash balance plans pass this test if the rate of accrual is the compensation credit to the employee's hypothetical account balance.

The first decision on the issue, involving *Onan* Corporation's cash balance plan, held that cash balance plans do not violate the age-based accrual requirements.[1] In this article, I argue that the district court, in a result-oriented opinion that ignores the language of the statute, arrived at the wrong answer. Not that I am overly optimistic that any court is likely to get the answer right and rule that the statute means what the statute so plainly says. Perhaps I am too cynical, but judicial fidelity to statutory language often seems inversely proportional to the magnitude of the consequences of such fidelity. And here the consequences loom large: the statute, applied as written by Congress, would force revision of the benefit accrual patterns

Norman Stein is the Douglas Arant Professor at The University of Alabama School of Law. He directs the University of Alabama Pension Counseling Clinic. He thanks Professor Edward Zelinsky and Rosina Barker for valuable comments on an earlier draft of this paper.

of the great majority of cash balance plans currently in existence (generally by requiring larger accruals for older employees). Judge David Hamilton, the *Onan* judge, alludes to these consequences repeatedly in the course of his opinion.

The judicial failure of nerves in *Onan* is unfortunate, which is my second point. Cash balance plans—invented by consultants to exploit the advantages of the defined benefit rules without actually providing true defined benefits for employees—raise serious tax and retirement policy issues, issues that haven't been adequately vetted in any legislative or regulatory forum. A ruling that cash balance plans violate IRC Section 411(b)(1)(H) and parallel ERISA and ADEA provisions would have the laudatory effect of forcing Congress and the regulatory agencies to focus on these issues and create appropriate limits on the cash balance form, limits which would protect reasonable employee benefit expectations and the federal fisc.

Before turning to these issues, I first outline why most cash balance plans violate the age-based accrual rules. In 1986 Congress added two age-based benefit provisions to ERISA, the Internal Revenue Code, and the ADEA—one applicable to defined benefit plans, one applicable to defined contribution plans. The one applicable to defined contribution plans is simple enough (actually, I am going to suggest it is not quite as simple as it seems when you throw in a special provision dealing with target benefit plans): it provides that a plan cannot reduce on account of age the allocations to a participant's account. For defined benefit plans, Congress provided a different rule: a plan cannot reduce "the rate of benefit accrual" on account of age.

A cash balance plan is a defined benefit plan; thus, it is subject to the latter rule. (No argument from the *Onan* court here.) But how do we judge whether a defined benefit plan's rate of benefit accrual declines with age? Well, Section 411 provides that the normal form of benefit in a defined benefit plan is an annuity commencing at normal retirement age. Thus, a traditional defined benefit plan would violate the age-based accrual rules if it provided, for example, that a 45-year-old accrued a $100 annuity commencing at normal retirement age, while a 46-year-old accrued a $99 annuity.

The normal form of benefit in a cash balance plan is also an annuity commencing at normal retirement age. The size of the annuity that accrues in each year is determined by the future value of the year's compensation credit at normal retirement age. Since a 46-year-old will have one less year of interest credit through normal retirement age than a 45-year-old, the amount available to purchase an annuity at normal retirement age will be lower for the 46-year-old. The rate of benefit accrual thus declines each year. (Professor Edward Zelinsky of Cardozo Law School, who believes that cash balance plans reflect good retirement policy, has illustrated this phenomena in a thoughtful article in the *Virginia Tax Review*.[2] Despite his support for cash balance plans as a policy matter, Professor Zelinsky concludes that all or most of them violate the age-based accrual rules.)

Advocates of cash balance plans thus have to argue that "rate of benefit accrual" in a defined benefit plan means something other than the rate at which the statutorily prescribed defined benefit accrues. And this is one of the two arguments that Judge Hamilton used to immunize cash balance plans from the age-based accrual rules.

The prelude to this argument is that the term "rate of benefit accrual" is not defined and therefore has to be divined from legislative history and "common sense." But there are two other provisions in the statute where the word "accrued" is used without serving as an adjective for the term "benefit" and in both cases courts and the agencies have had no hesitation, doubt, or difficulty concluding that they refer to the "accrued benefit." The first is IRC Section 411(d)(3), a provision with pre-ERISA roots, which provides that "benefits accrued" to date must vest on plan termination. Cases dealing with this provision treat the term "benefits accrued" as the accrued benefit.[3]

The second provision is ERISA Section 204(h), which requires that a plan administrator notify participants if there is a "significant" decline in the "rate of future benefit accrual." Note that this language here is virtually identical to that in the age-based accrual rules. In its regulations on Section 204(h), the Treasury Department ruled that the term "rate of future benefit accrual" refers to the rate of accrual of the statutory accrued benefit, that is, "the annual benefit commencing at normal retirement age."[4] The preamble explained that "the statutory phrase 'rate of future benefit accrual' implies, on its face, that section 204(h) is limited to changes in the accrued benefit."[5] There is thus, at the least, a strong statutory implication that the term "rate of benefit accrual" must be measured in relation to the statutory accrued benefit.

The district court, however, held that in the context of a cash balance plan it simply does not make sense to use the "accrued benefit," because, according to the court, cash balance plans provide a different kind of benefit than other defined benefit plans—the accruing benefit is not an annuity payable at normal retirement age, but the hypothetical account balance. And the court believed that a different rule should be used for cash balance plans, one that was consistent with the type of benefit such a plan provided.

But the court misunderstood a fundamental principle under the statute: a cash balance plan *is* a defined benefit plan and the normal form of benefit under *every* defined benefit plan, not just so-called traditional defined benefit plans, is an annuity commencing at normal retirement age. (Indeed, under the statute, a cash balance plan is just a defined benefit plan that happens to offer a lump sum distribution option.) There is not one set of rules for traditional defined benefit plans and another set of rules for cash balance plans.

This, in a way, gets to the heart of the controversy over cash balance plans. The pension consulting industry cobbled into being a plan design intended to deliver for employers some tax and funding benefits of defined benefit plans without delivering true defined benefits to their employees. Congress never approved this form of plan, never intended to separate the tax and funding benefits that an employer could reap from a defined benefit plan from the advantages defined benefit plans deliver to employees. But that is exactly what the cash balance inventors intended their cleverly designed contraptions to accomplish.

To do this, though, cash balance plans have to satisfy all the formal statutory conditions for real defined benefit plans. The Eleventh Circuit and Second Circuit Courts of Appeals have already reversed lower court decisions that tried to rewrite statutory rules to negotiate certain cash balance plans through an inconvenient confluence of ERISA backloading standards and the ERISA requirement that a lump sum benefit in a defined benefit plan be the actuarial equivalent of a single-life annuity commencing at normal retirement age.[6] And this is also what the district court in *Onan* did: changed the rules for defined benefit plans to accommodate the peculiar features of cash balance plans. The court, in effect, is engaging in a legislative-type policy decision—that Congress wanted to accommodate cash balance plans with rules that exempt them from those inconvenient regulatory requirements that they fail to satisfy.[7]

If we needed a further key to unlock congressional intention, the statute gives us one. IRC Section 411(b)(2), which prescribes the age-based rules for defined contribution plans, provides that Treasury "shall provide by regulation for the application of the requirements of this paragraph to target benefit plans." Why a special rule for target benefit plans? In a target benefit plan, a hybrid plan in which contributions mimic annual funding of a defined benefit, allocations *increase* with age through normal retirement age. They would thus automatically satisfy the "equal allocation" rules applicable to defined contribution plans generally until age 65. (Indeed, they surpass those rules since older employees get larger allocations than younger employees.) The explanation for this provision, then, must be that Congress thought it might be inappropriate to test a defined contribution plan whose accrual pattern is based on target "benefits" on an equal cost basis, and left it for Treasury to flesh out this concern in a regulation project.

Thus, the statute provides that an equal cost rule might not be appropriate even for all defined contribution plans. And this is powerful support for the idea that "equal allocation" was not what Congress had in mind when it prohibited defined benefit plans from reducing the rate of an employee's benefit accrual, for it didn't even necessarily mean that all defined contribution plans should be measured on an equal allocation basis.

One can respond to this, of course, by arguing that the special provision for target benefit plans shows that Congress intended for so-called hybrid plans to be judged differently from other plans in their respective defined contribution or defined benefit family. But Congress provided a special provision for only one type of "hybrid" plan: the target benefit plan. It must have done this because it thought without that provision target benefit plans would be treated as other defined contribution plans.

The district court, perhaps sensing the fragility of its reasoning, offered another basis for its holding: that the age-based accrual rules apply only to employees who have attained normal retirement age. The district court, all but conceding that this is not what the statutory language itself says, relies entirely on snippets of legislative history, but principally on an example in the Conference Committee Report in a section explaining how the age-based accrual rules operate when an employee returns to work after benefits have commenced. In such situations, ERISA and the Internal Revenue Code permit the plan to suspend the already-started benefits, in essence forfeiting the benefits during the period of reemployment. The statute refers to this as a "suspension of benefits."

The Conference Report includes a section titled "SUSPENSION OF BENEFITS," which begins with the statement that "The Conference agreement does not alter the rules of existing law concerning the suspension of benefit payments to employees who are reemployed after attaining normal retirement age." The section then notes that a "defined benefit plan complying with the suspension of benefits rule is required to provide additional benefit accruals but would not have to recommence payments until the employee actually retires." The section then immediately provides an example illustrating these rules. The example, by definitional force, involves an employee subject to the suspension-of-benefit rules: someone who returns to employment after normal retirement age. Judge Hamilton, apparently without understanding that the example illustrates the operation of the suspension-of-benefit, viewed the example as proof that the new age-based accrual rules only apply to employees who have attained age 65.[8] This is a fragile foundation on which to argue that the language of the statute should be discarded.

Moreover, the ADEA age-based accrual provisions includes a subset of rules applicable by its terms to those employees who have reached normal retirement age. That Congress saw a need to identify these rules as applicable only to employees who have reached normal retirement age is inconsistent with Judge Hamilton's holding that the age-based accrual rules in their entirety are limited to such employees. Judge Hamilton's opinion does not acknowledge this section, let alone its inconsistency with his opinion.

Finally, it is irrational to assume that Congress wished to protect employees over age 65 from age-based reductions in a plan's accrual rate, but thought that employers should be able to reduce accrual rates for other older employees generally protected against age discrimination (for example, a 64-year-old). Judge Hamilton suggests that other older employees are protected by the intentional age discrimination rules under ADEA, but the ADEA explicitly provides that "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." In the *Onan* universe, such employees would be stranded with no protections from reductions in benefit or allocation rates on account of age.

I turn now to an important point in a recent paper by Alvin Lurie.[9] Mr. Lurie notes that "Congress cannot be deemed to have meant, by passage of a law adopted almost contemporaneously with the adoption of the first cash balance plan, to prescribe a measuring rod for establishing discriminatory age practices that would essentially illegalize the cash balance model." I agree with Mr. Lurie here: I don't think that Congress intended to illegalize cash balance plans, but I also find nothing in ERISA, the Internal Revenue Code, or the ADEA, that suggests—even remotely—that Congress wished to endorse such plans.

Congress simply had not thought about cash balance plans; the age-based accrual rules were written neither to accommodate or illegitimize them. As already noted, the inventors of the cash balance plan intended for the plan to satisfy the regulatory requirements for defined benefit plans, although without providing participants with the advantages that we ordinarily associate with defined benefit plans. The age-based accrual requirement is simply a defined benefit hole into which the cash balance peg does not fit.

The statutory arguments that Section 411(b)(1)(H) means something very different than what its words say are thus unpersuasive. But to return to Mr. Lurie's (and the *Onan* court's) policy argument: how can anyone argue that a cash balance plan, in which all employees earning the same compensation get the same hypothetical account addition, discriminates on the basis of age. The 25-year-old, 45-year-old, and 55-year-old earning identical compensation receive the same addition to their hypothetical account. If this is age discrimination, then every defined contribution plan (except cross-tested plans or target benefit plans) must also be age discriminatory.

As I have already noted, though, I agree the accrual patterns in cash balance plans do not discriminate against older employees on a cost, or present-value basis. But this is beside the point. Congress did not craft a cost-basis scheme for measuring the legality of decreasing benefit accruals in defined benefit plans. It provided, simply and plainly, that the rate of benefit accrual could not decline. There is certainly a policy basis for asking Congress to revisit this question in light of cash balance plans and I invite advocates of cash balance plans to take their argument to Congress.

But I also think there are pretty strong policy arguments against the unrestricted use of the cash balance form. Most of the objections to the cash balance form have come in the context of conversions, where the expectations of older employees that they would accrue significant benefits in their later years of employment, and where normal and early retirement benefits often stop accruing for long periods of time (the "wear away" issue). Conversions also have been branded (by me, among others) as a strategy to avoid the tax on reversions, a tax that would be applied to overfunded defined benefit plans converted into true defined contribution plans. I agree that these objections are the most serious lodged against cash balance plans, but there are other substantial policy concerns with cash balance plans that have not received sufficient airing, including the manipulation of defined benefit funding rules to achieve aggressive tax avoidance; the probable acceleration of the current trend to lump sum rather than annuitized benefits; the below-market rate of return on most hypothetical cash balance accounts and the possibility of employees consequently overvaluing compensation credits. Also, there are many technical issues that probably need legislative attention if Congress wants to accommodate cash balance plans in any form.[10]

I want to end by returning once more to the principal point of cash balance advocates in the age-based accrual debate: that the accrual patterns in cash balance plans are no worse for older employees than the accrual patterns in defined contribution plans. As already noted, this is true on a present value basis. And I agree that this is not one of the objectionable policy features of the cash balance plan form (aside from the conversion issue). But as I have also noted, there are substantial reasons to object to many aspects of the cash balance form.

Perhaps it is unfortunate that the very real concerns and issues with the cash balance form are not what cause cash balance plans to violate federal statutory requirements for defined benefit plans. And perhaps it is equally unfortunate that the age-based accrual rules, which cash balance plans flunk if courts apply those rules as they are written, do not relate to the serious policy shortcomings of the cash balance plan form itself.[11] If they did, the *Onan* court might have found it easier to respect the statutory language. But flunk the age-based accrual rules cash balance plans do and they do not, in my view, deserve judicial creativity to rescue them from their failure to comply. Let Congress do any rescuing and in the process assure that cash balance plans comport with, rather than undermine, tax and retirement policy.

NOTES

1. *Eaton v. Onan Corporation*, 117 F.Supp. 2d 812 (S.D. IN. 2000).

2. Edward A. Zelinsky, "The Cash Balance Controversy," 19 *Va. Tax Rev.* 683 (2000).

3. See, e.g., *Mead Corp. v. Tilley*, 490 U.S. 714 (1989); *Bennet v. Conrail Matched Savings Plan Administrative Committee*, 168 F.3d 671 (3d 2000); *Chile v. Ceridian Corp.*, 95 F.3d 1505 (10th 1996); *Borst v. Chevron Corp.*, 36 F.3d 1308 (5th Cir. 1994).

4. Treas. Reg. §411(d)-6, Q&A 5.

5. Final Regulations, Notice of Significant Reduction in the Rate of Future Benefit Accruals, 63 Fed. Reg. 68678 (Nov. 14, 1998).

6. See *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000); *Lyons v. Georgia Pacific Corp. Salaried Employee Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000).

7. There are two articles that also argue that the rule against age-based reductions should not be measured against a plan's accrued benefit. See Rosina B. Barker & Kevin P. O'Brien, "Do Cash Balance Plans Violate the ADEA?," 13 *Benefits Law Journal* 75; Richard C. Shea, Michael J. Francese & Robert S. Newman, "Age Discrimination in Cash Balance Plans: Another View," 19 *Va. Tax Rev.* 763 (2000). The reasoning in these articles is more sophisticated than that used in the *Onan* decision, since in neither

article does it rest on the view that cash balance plans are subject to different rules than other defined benefit plans. Rather, the authors of these articles argue that the statute, taken as a whole, shows that Congress could not have meant that the statutory accrued benefit should be the measuring stick for determining whether an employee has suffered an age-based reduction in the rate of benefit accrual in a defined benefit plan.

In the Barker/O'Brien article, the more thoughtful of the two, the authors argue that interpreting the term "rate of benefit accrual" to refer to the accrued benefit is inconsistent with two other parts of the statute. First, the statute specifically provides "that the rate-of-benefit-accrual rule is not violated merely because any early retirement subsidy is disregarded in determining benefit accruals." But the authors note that the term "accrued benefit" itself does not apply to early retirement benefits. If Congress had intended the term "rate of benefit accrual" to apply to the statutory accrued benefit, it would have been unnecessary to provide a specific exception in IRC §411(b)(1)(H) for early retirement benefits. In 1986, however, the question of whether a subsidized early retirement benefit was part of the accrued benefit being litigated and Congress might have therefore believed the exception might prove necessary. See *Amato v. Western Union International, Inc.*, 773 F.2d 1402 (2d Cir. 1985)(subsidized early retirement benefit part of accrued benefit).

Barker and O'Brien also argue that another statutory anomaly would occur if the age-based accrual rules are applied with respect to the statutory accrued benefit. Those rules include an offset provision for any post-normal-retirement-age actuarial upward adjustments in benefits provided by the plan. The authors then argue that under IRC §411(a)(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." Thus, this section would mean that the accrued benefit would include an adjustment nullifying the offset if the accrued benefit was used to measure reductions in the rate of benefit accrual. But Section 411(a)(3) is part of a section that is used to determine the portion of an accrued benefit attributable to employee contributions in a contributory defined benefit plan (this portion of the accrued benefit must be vested at all times). It has no application to individuals after normal retirement age, since such individuals are also vested in their employer-provided benefit. The regulations themselves specifically provide that "no actuarial adjustment to an accrued benefit is required on account of employment after normal retirement age." Treas. Reg. §1.411(c)-(f)(2). The Barker-O'Brien article does include an elegant and clear statement of the problem and of the history of the age discrimination issues in pension plans.

The Shea/Francese/Newman article has an everything-but-the-kitchen-sink quality to it and advances arguments that seem to me to overreach. Without any fully engaged analysis of the statute itself, the authors conclude that the amount of a hypothetical immediate annuity purchase each year should be the basis by which a decline in the rate of benefit accrual should be determined. Aside from the lack of any support for this proposition under the language of the statute, the immediate annuity test advanced in the Shea article would tolerate a *shrinking* hypothetical allocation as an employee ages, since the life expectancy of the employee would decrease annually. Thus, defined benefit plans could sometimes be designed to provide lower effective hypothetical additions for a person as they age, certainly not something that Congress could have plausibly intended.

Shea, Francese, and Newman also contend that IRC §411(c) is incompatible with the idea that reductions in the rate of accrual could apply to the accrued benefit, since the method in which the accrued benefit is attributed to employee contributions parrots that of the cash balance plan model. But Section 411(b)(1)(H) applies to the entire accrued benefit, not separately to the employer and employee funded portions of it. The authors also contend that a plan that provided a fixed benefit after normal retirement age would violate Section 411(b)(1)(H) if an annuity continued to grow at the same levels as it did before normal retirement age, since in their view the annuity would have to be converted to an equivalent age-65 annuity. If this were so, an example in the legislative history involving accruals after normal retirement age would actually violate the statute. But the statute does not require the actuarial conversion of a post-normal-retirement-age accrual to an age-65 equivalent annuity; indeed, as I noted above, Treasury regulations make clear that the accrued benefit earned in a year after normal retirement age is only the addition to the overall annuity amount. Treas. Reg. §1.411(c)-(f)(2). Finally, the authors contend that because the plan does not refer to age but only has the effect of reducing the rate of benefit accrual as employees age, that Section 411(b)(1)(H) is not violated. This interpretation would, of course, allow any firm to evade the requirements of the statute by designing a plan so it has the effect of reducing the rate of benefit accrual because of age without explicitly mentioning age. And as Professor Zelinsky noted, "the reality [is] that the statutes three times declare as unlawful discrimination declines or stoppages of benefit accruals based on 'any age,' not 'any age specified in the plan." See Edward A. Zelinsky, "Age Discrimination and Fidelity to Statutory Text," 20 *Va. Tax. Rev.* 559 (2001). The Zelinsky article is a response to the Shea/Francese/Newman article and is an elegant explication of Professor Zelinsky's view of statutory interpretation. See also "Travelers, Reasoned Textualism, and the New Jurisprudence of ERISA Preemption," 21 *Cardozo L. Rev.* 807, 839-58 (1999)(developing and applying theory of "reasoned textualism").

8. Judge Hamilton also relied on a statement in the Conference Committee that the new rules 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. This statement, though, leads into an illustration that makes clear that the new rules do not invalidate the fractional method of accrual, a possibility under a strained interpretation of the new rules even though the fractional rule provides for even rates of accrual for each employee. It is unreasonable to think that the Conference Report was anything more than a clarification that plans could continue using the fractional rule. There is no evidence that Congress intended reduction of benefit accrual rates for 64-year-olds but not 65-year-olds. In addition, Judge Hamilton relied on statements added to the Congressional Record by four members of Congress but not actually delivered on the floor. The totality of the legislative history relied upon by Judge Hamilton is a slim foundation on which to rewrite the unambiguous language that Congress put in the statute.

9. Alvin D. Lurie, "Age Discrimination or Age Justification: The Case of the Shrinking Future Interest Credit under Cash Balance Plans," 54 *The Tax Lawyer* 299 (2001).

10. Among the technical issues are those involving PBGC guarantees and the Section 415 limitations.

11. The age-based accrual rules, however, do relate to the dashed expectation of older employees caused by many conversions of traditional defined benefit plans to cash balance plans.