COMMENTS CONCERNING AGE DISCRIMINATION ISSUES IN CASH BALANCE PENSION PLANS

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The following comments (the “Comments”) are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the Committee on Employee Benefits of the Section of Taxation of the American Bar Association (the “Section”). Substantive contributions were made by Harry Conaway, Susan Daley, Elizabeth Drigotas, Margery Friedman, Judith Mazo, Priscilla Ryan, Pamela Scott, Steven Spencer, and Robert Stevenson. The Comments were reviewed by Pamela Baker of the Committee on Employee Benefits, David Cowart of the Section’s Committee on Government Submissions and by Elaine Church, Council Director.

Although members of the Section who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

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I. Executive Summary

On October 20, 1999, the Internal Revenue Service (the "Service") and the Treasury Department published a notice soliciting public comment on cash balance plans, including issues relating to age discrimination in cash balance plans. In response to that solicitation, this Comment will address five principal questions (with related subsidiary issues):

1. Does the operation of the interest credit in cash balance plans inherently discriminate because of age?
2. Does the method of calculating the single sum distribution in some cash balance plans discriminate because of age?
3. Does the conversion of final average pay defined benefit plans to cash balance plans discriminate because of age?
4. Does the treatment of some ancillary benefits and optional forms of benefit associated with the cash balance formula in some types of conversions discriminate because of age?
5. Does the "wear-away effect" which can result from such conversions discriminate because of age?
6. Does enhancing the transition benefits available to some members of the protected class have age discrimination implications?
   1. What consideration should be given if factors other than age (such as declining interest rates) exacerbate the "wear-away" effect?
The Comment will provide some factual and legal background, then discuss the foregoing issues.

II. Background

A. Factual Background and Notice 96-8

Cash balance plans are defined benefit pension plans under the Internal Revenue Code of 1986, as amended (the "Code") and the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), because they do not meet the laws' definitions of defined contribution or individual account plans, which must provide for an individual account for each participant and for benefits based solely upon the amount contributed to that account, plus its share of income, expenses, gains, losses and forfeitures. They are unlike traditional defined benefit plans, however, which typically provide a fixed annual retirement benefit equal to the product of the number of years of the employee’s credited service, his final (or career) average salary, and a percentage. For example, a traditional plan might provide for an employee to receive one and one-half percent of his final average pay times his years of service, up to a maximum of 30 years of service. This would result in a maximum annual pension benefit equal to 45 percent of the individual’s final average salary.

Cash balance plans are not designed to target a percentage of final (or career) average pay in the same manner as traditional defined benefit plans. Instead, the benefit under a cash balance plan is based upon a hypothetical investment account established for the employee, plus hypothetical investment earnings on such account. Employee accounts receive hypothetical allocations each year and hypothetical earnings credits. Annual allocations may be based on a percentage of pay or another factor. Earnings credits may be determined using a set interest rate, or may be pegged to a variable outside index, such as one-year Treasury securities. (For the sake of simplicity, the Comment will refer to these account additions as "interest credits," although there are some cash balance plans which base earnings credits on equity indices, such as the return on the S&P 500 index or the return of a specified mutual fund which holds equity securities.)

The employee’s benefit is "defined" and communicated as the amount held in the hypothetical account, regardless of the actual earnings of the plan over the years. The cash balance plan looks like an individual account plan in the sense that the benefit is equal to an account balance, but the employee is not entitled to the gains that exceed the interest credit. On the other hand, the employee does not suffer investment losses; the employer is obligated to fund the defined benefit even if the plan does not obtain the investment experience equal to the earnings credits that are made to the participants’ hypothetical accounts.

In Notice 96-8, 1996-1 C.B. 359 (the "Notice"), the Service discussed its views regarding possible guidance relating to the application of the benefit accrual rules of section 411(b)(1) of the Code to cash balance plans, but did not expressly address age discrimination concerns. In the Notice, the Service expressed its view that the accrued benefit in a cash balance plan must be expressed as an annuity commencing at normal retirement age, at least for the purpose of applying the accrual rules. The Service further
stated that because retirement benefits at normal retirement age under a cash balance plan are based on the hypothetical account balance including the interest credits, future guidance might provide that the benefits attributable to the interest credits must be taken into account in determining whether the accrual rules are satisfied.

The Notice described two methods under a cash balance plan pursuant to which participants can accrue benefits attributable to interest credits. Under the Notice, in a "frontloaded" interest credit plan, benefits attributable to future interest credits with respect to a hypothetical allocation will accrue at the same time that the benefits attributable to the hypothetical allocation itself accrue. In a "backloaded" interest credit plan, future interest amounts would only be credited to an employee's account as the employee earns future service. In that case, the benefits attributable to the interest credits would not accrue until the account is credited. The Service noted that future guidance might provide that backloaded plans "typically will not satisfy any of the accrual rules in section 411(b)(1)(A), (B) or (C)," thus implicitly approving only frontloaded cash balance plans. The Notice stated that because backloaded plans typically would not satisfy the accrual rules of sections 411(b)(1)(A), (B), or (C), the Service intended only to address frontloaded interest credit plans in future guidance. The extent to which the Notice is binding on taxpayers has been unclear at best, as the Notice is simply a statement of intention to issue proposed regulations. No such regulations have yet been proposed.

B. Policy Considerations

Cash balance plans have attracted significant public comment only in the past year or so, although the first favorable determination letter was issued in 1985. In light of the history of governmental acceptance of these plans, it may be worthwhile to review some of the reasons that such plans in the past have found such acceptance, in addition to some of the policy-related concerns that have been raised by the media and in class action litigation.

While the fact that cash balance plans are defined benefit plans makes them controversial, it is also seen as one of their strengths. Defined benefit plans provide a "safety net" type benefit which, unlike the benefit under a defined contribution plan, cannot be eliminated or reduced by poor investment experience of the plan. Other attractive features of a defined benefit plan are that the employer rather than the employee bears mortality risk, and that benefits can be offered in a defined benefit plan that are unavailable in a defined contribution plan, such as cost of living increases, past service benefits, and ancillary death or disability benefits. Accordingly, it may be worthwhile as a public policy objective to enhance the attractiveness of sponsoring defined benefit plans to private sector employers, and cash balance plans have been touted by some as a means of keeping employers in the defined benefit plan system. 

Despite the advantages of defined benefit plans, many employers see them as too expensive to administer with design options that are too inflexible, and believe that many employees do not appreciate or understand defined benefit plans. In contrast, cash balance plans have been popular with employers as a means of providing portable and easily communicated benefits to workers through a defined benefit plan. Some employers view cash balance conversions as an alternative to freezing or terminating
their defined benefit pension plans. In the absence of a cash balance alternative, it is likely that some large employers will consider freezing or even terminating their defined benefit pension plans, and a few will likely do so, despite the tax and other costs of terminating a plan. In particular, as "new economy" employers without defined benefit plans grow and acquire employers with defined benefit plans, freezing accruals for those already covered with no additional expansion of coverage is likely to become the norm. In such a scenario, plan terminations become more likely, and if an employer’s primary motive in converting to cash balance is to reduce costs in general, in the absence of a cash balance alternative, terminations become more likely.

In some cases, employers have reduced overall benefit expenses in connection with adopting a cash balance plan, although in other cases, employers have combined a conversion with an enhancement to a section 401(k) plan or other benefit enhancements. 4 In particular, conversions typically eliminate early retirement subsidies for future service. These subsidies were intended to encourage older workers to retire prior to normal retirement ages.

There are concerns with the basic cash balance design, but much of the recent focus has been on conversions. Although other concerns have been raised, two basic policy-related themes have been raised in criticizing recent cash balance plan conversions:

- In many conversions, some workers receive less valuable pension benefits than they would have received had the plans not converted, and this effect hurts older workers more than younger workers in the same plan. At a time when Social Security and other benefits are at risk, the minority of workers who are fortunate enough to have a defined benefit plan should, under this theory, have their expectation of future benefits protected.
- Even where communications comply with existing law, the effect of the conversion has in some cases not been understood by many workers. As a result, workers cannot plan properly for the consequences of the conversion.

The second point, regarding communications, although important, is beyond the scope of this Comment. The first point has more bearing on age discrimination issues, and will be explored in more detail below.

C. Legal Background

Many of the concerns relating to age discrimination may be resolved with reference to a common legal background. Accordingly, the details regarding the relevant law are summarized below.

1. General Provisions of the ADEA

ADEA prohibits discrimination in employment because of age. Section 4(a) of ADEA provides:

(a) Employer practices

It shall be unlawful for an employer—
(1) to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age;

(2) to limit, segregate, or classify his employees in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's age; or

(3) to reduce the wage rate of any employee in order to comply with this chapter.

(Emphasis supplied.)

The ADEA also contains a number of requirements expressly applicable to pension plans. These include section 4(i)(1)(A) of the ADEA, which prohibits an employer from establishing or maintaining "an employee pension benefit plan which requires or permits... in the case of a defined benefit plan, the cessation of an employee's benefit accrual, or the reduction of the rate of an employee's benefit accrual, because of age...." Section 4(i)(2) of the ADEA provides:

Nothing in this section shall be construed to prohibit an employer, employment agency, or labor organization from observing any provision of an employee pension benefit plan to the extent that such provision imposes (without regard to age) a limitation on the amount of benefits that the plan provides or a limitation on the number of years of service or years of participation which are taken into account for purposes of determining benefit accrual under the plan.

Thus, the ADEA prohibits the cessation of or reductions in accruals because of a participant's age, but it permits plans to place a cap on the service that will be credited or the benefit amounts that will be paid for reasons other than age.

In addition to several other pension-specific provisions that are inapplicable here, the ADEA contains two provisions recognizing the use of a normal retirement age in pension plan design. Section 4(i)(8) of the ADEA states:

A plan shall not be treated as failing to meet the requirements of this section solely because such plan provides a normal retirement age described in section [3(24)(B) of ERISA] and section 411(a)(8)(B) of [the Code].

Section 4(l) of the ADEA states:

Notwithstanding clause (i) or (ii) of subsection (f)(2)(B) of this section-

(1) It shall not be a violation of subsection (a), (b), (c), or (e) of this section solely because—

(A) an employee pension benefit plan (as defined in section 3(2) of ERISA) provides for the attainment of a minimum age as a condition of eligibility for normal or early retirement benefits; or
(B) a defined benefit plan (as defined in section [3(35) of ERISA] provides for—

(i) payments that constitute the subsidized portion of an early retirement benefit; or

(ii) social security supplements for plan participants that commence before the age and terminate at the age (specified by the plan) when participants are eligible to receive reduced or unreduced old-age insurance benefits under title II of the Social Security Act…and that do not exceed such old-age insurance benefits.

Note that Section 4(f)(1) of the ADEA provides that employment actions based on "reasonable factors other than age" are insulated from age discrimination complaints, even if they would otherwise be prohibited under the ADEA.

2. Other "Rate of Benefit Accrual" Statutes Related to Age

As stated previously, section 4(i)(1)(A) of the ADEA provides:

Except as otherwise provided in this subsection, it shall be unlawful for an employer, an employment agency, a labor organization, or any combination thereof to establish or maintain an employee pension benefit which requires or permits ... in the case of a defined benefit plan, the cessation of an employee’s benefit accrual, or the reduction of the rate of an employee’s benefit accrual because of age.

Section 204(b)(1)(H) of ERISA provides:

Notwithstanding the preceding subparagraphs, a defined benefit plan shall be treated as not satisfying the requirements of this paragraph if, under the plan, an employee’s benefit accrual is ceased, or the rate of an employee’s benefit accrual is reduced, because of the attainment of any age.

Section 411(b)(1)(H) of the Code provides:

(H) Continued accrual beyond normal retirement age.

(i) In general. Notwithstanding the preceding subparagraphs, a defined benefit plan shall be treated as not satisfying the requirements of this paragraph if, under the plan, an employee’s benefit accrual is ceased, or the rate of an employee’s benefit accrual is reduced, because of the attainment of any age.

(ii) Certain limitations permitted. A plan shall not be treated as failing to meet the requirements of this subparagraph because the plan imposes (without regard to age) a limitation on the amount of benefits that the plan provides or a limitation on the number of years of service or years of participation which are taken into account for purposes of determining benefit accrual under the plan.
In summary, Congress placed the same prohibition against certain age discrimination under defined benefit plans in three statutes. The ADEA furthermore grants the Secretary of the Treasury the authority under the ADEA to construe the accrual requirements of both the ADEA and the Code. The Secretary of the Treasury also has the authority to construe these requirements under ERISA pursuant to Reorganization Plan No. 4.

Section 411(b)(1)(H)(i) of the Code is preceded by the heading, "Continued Service Beyond Normal Retirement Age." The foregoing requirement can be read as applying only to accruals after normal retirement age, and not before then. Although the similar provisions of ERISA and ADEA did not have the relevant subheading, all three were enacted as part of the Omnibus Budget Reconciliation Act of 1986 ("OBRA '86"), in the sections of OBRA '86 which dealt only with benefit accruals beyond normal retirement age, not just at any age. Moreover, there is substantial language in the Conference Committee Report to OBRA '86 and other legislative history to that act which would support that view.

In contrast, Congress provided for different treatment for defined contribution plans. Section 411(b)(2) provides that defined contribution plans comply with age discrimination rules "if, under the plan, allocations to the employee’s account are not ceased, and the rate at which amounts are allocated to the employee’s account is not reduced, because of the attainment of any age." Although the defined contribution rules are not directly relevant to a cash balance plan, they may be useful to keep in mind as the analysis proceeds. If the principles of section 411(b)(1)(H) were applied to defined contribution plans, those plans would likely be considered age discriminatory. The value of a given amount of employer contributions declines as a participant ages, because the allocation has a shorter period over which to accumulate investment earnings. Accordingly, the rate of "accrual" under a defined contribution may appear to decline as a participant ages. Section 411(b)(2) accordingly may provide the basis for the view that Congress did not intend to outlaw account-based plans on the basis of age discrimination.

3. Proposed Regulations under Section 411(b)(1)(H) of the Code

In 1988, the Service issued proposed regulations that address selected aspects of age discrimination under section 411(b)(1)(H) of the Code. The proposed regulations do not address cash balance issues, as the regulations were issued before cash balance plans had acquired significant popularity. The proposed regulations do not define "rate of accrual" for purposes of section 411(b)(1)(H), and examples of discriminatory benefit formulas cited in the regulations do not use the age 65 annuity as the basis for determining whether age discrimination existed. In general, the proposed regulations provide that a pension plan will not engage in age discrimination solely because of a positive correlation between an increase in age and a reduction in or suspension of benefit accruals. Prop. Reg. § 1.411(b)-2(a).

Although the proposed regulations do not address cash balance plans in particular, they do address the distinction between age and years of service until
retirement. In the context of a plan using the fractional benefit rule of section 411(b)(1)(C) of the Code, the proposed regulations state that such a plan "will not fail to satisfy [the rules because the] rate at which a participant's normal retirement benefit accrues differs depending on the number of years of credited service a participant would have between the date of commencement of participation and the attainment of normal retirement age." Prop. Reg. § 1.411(b)-2(b)(3)(i). This distinction may be important in the analysis of cash balance plans, as explained in more detail below.

4. Final Regulations under Section 401(a)(4)

Regulations under section 401(a)(4) of the Code provide safe harbors under which plans, if designed properly, may prove compliance with the nondiscrimination rules under such section. One of those safe harbors addresses cash balance plans. Treas. Reg. § 1.401(a)(4)-8(c). This was the first generally applicable official recognition of cash balance plans (although favorable determination letters had previously been issued). Apparently because some commentators had raised questions about possible age discrimination issues under cash balance plans, the Service explained, in the preamble to the regulations, that cash balance plans that satisfied the safe harbor requirement were not age discriminatory in T.D. 8360 (56 FR 47524 – 47603, September 12, 1991):

The fact that interest adjustments through normal retirement age are accrued in the year of the related hypothetical allocation will not cause a cash balance plan to fail to satisfy the requirements of section 411(b)(1)(H), relating to age-based reductions in the rate at which benefits accrue under a plan.

5. Case Law

Two basic types of claims of age discrimination may be made under ADEA – a "disparate treatment" claim or a "disparate impact" claim. Very generally, a disparate treatment claim applies when an employer discriminates against a member of the protected class because of age. The plaintiff must generally prove that the employer had an intent to discriminate. A disparate impact claim is made when a facially neutral policy or act by an employer has the effect of adversely affecting the protected class and the policy or act does not have a business purpose. The plaintiff is not required to prove that the employer had a discriminatory intent.

a. Disparate Treatment

The primary Supreme Court case involving a disparate treatment claim in the context of a pension plan is Hazen Paper Co. v. Biggins, 507 U.S. 604 (1993). In deciding the case, the Supreme Court focused on the extent of the improper intent needed to find a violation of the ADEA. The Supreme Court has made it clear that a claim of age discrimination based on a disparate treatment theory cannot succeed under the ADEA if the
motivating factor for the challenged action was something other than age itself. The employee’s protected trait had to actually play a role in the employer’s decision-making process and must have had a "determinative influence" on the outcome. The Court held that even a positive correlation between a motivating factor and age is not sufficient to establish a violation. The Court found that an employer’s decision to discharge an older employee to interfere with the vesting of his pension benefits does not state an ADEA claim, though it might state a claim under the antidiscrimination provision of ERISA. The Court overruled cases such as White v. Westinghouse Electric Co., 862 F.2d 56, 62 (3d Cir. 1988) (firing of older employee to prevent vesting of pension benefits violates ADEA) and Metz v. Transit Mix, Inc., 828 F.2d 1202 (7th Cir. 1987) (firing of older employee to save salary costs resulting from seniority violates ADEA).

The Court emphasized that the problem of inaccurate and stigmatizing stereotypes—the primary concern behind the passage of the ADEA -- disappears when the employer’s decision is motivated by factors other than age, and that, therefore, liability depends on whether age actually motivated the employer’s decision. In so holding, the Court recognized the distinction between age and other factors relevant under a pension plan, such as years of service:

On average, an older employee has had more years in the work force than a younger employee, and thus may well have accumulated more years of service with a particular employer. Yet an employee’s age is analytically distinct from his years of service. An employee who is younger than 40, and therefore outside the class of older workers as defined by the ADEA, see 29 U.S.C. §631(a), may have worked for a particular employer his entire career, while an older worker may have been newly hired. Because age and years of service are analytically distinct, an employer can take account of one while ignoring the other, and thus it is incorrect to say that a decision based on years of service is necessarily age-based.

A key element of a disparate treatment claim is the employer’s discriminatory intent or “animus.” In Goldman v. First Nat'l Bank of Boston, 985 F.2d 1113 (1st Cir. 1993), the plaintiff claimed that his employment was terminated impermissibly by reason of age discrimination. Plaintiff furthermore claimed that the employer’s conversion of its final average pay plan to a cash balance plan was evidence of the discriminatory animus. The Court rejected that claim, finding that there was "no evidentiary foundation for the premise that the new plan disadvantages older employees." The court did not find that the plan was nondiscriminatory; rather, the court said that the plaintiff had simply failed to present sufficient evidence. Nonetheless, the court appeared to give some weight in its finding of no discriminatory animus to the fact that the employer permitted employees age 55 with at least 10 years of service or any employee with at least 20 years of service to
remain under the prior plan formula.

b. Disparate Impact

The concurring opinion in *Hazen Paper* written by Justice Kennedy (joined by two other Justices) suggested that it is not proper to carry over the disparate impact theory from Title VII to ADEA. The theory for limiting the ADEA to disparate treatment claims starts with the recognition that the ADEA was passed because of congressional concern that older workers were disadvantaged as a result of inaccurate stereotypes. Where an employment decision is motivated by factors other than age (and thus devoid of the requisite intent for a disparate treatment claim), the rationale for the ADEA is not implicated. See *Mullin v. Raytheon Co.* 164 F.3d 696, 700 (1st Cir. 1999); *cert. denied* 120 S.Ct. 44 (1999). The courts have also found that the language of 29 U.S.C. § 623(f)(1), permitting employers to take otherwise unlawful actions "where the differentiation is based on reasonable factors other than age," must be read to prohibit disparate impact claims. As Judge Selya commented in *Mullin*, "if the exception contained in section 623(f)(1) is not understood to preclude disparate impact liability, it becomes nothing more than a bromide to the effect that 'only age discrimination is age discrimination'." *Id.* at 702.


None of the foregoing cases have discussed cash balance plans. The conclusion one can draw is that, in light of the law developing which appears to require a finding of discriminatory intent, agencies should be careful to avoid prohibiting, on age discrimination grounds, any category of benefit design which could be implemented with a motive unrelated to
Moreover, because the Supreme Court may ultimately decide whether disparate impact claims exist under ADEA, the agencies may want to issue guidance that distinguishes pensions or even cash balance plans as separate cases, so that any guidance will be applicable regardless of any ultimate Supreme Court decision of this issue.

III. Interest Credit Issue

1. Issue: Does the operation of the interest credit in cash balance plans inherently discriminate because of age in a prohibited manner?

   Interest credits are generally available until the participant takes a complete distribution from the plan, regardless of his or her age or whether he or she is still employed by the plan sponsor. In most plan designs, the same rate of interest credit is available to both older and younger participants. In order to comply with the limits on backloading, a frontloaded interest credit plan treats all interest credits through normal retirement age as accrued in the same year as the contribution credit. Under this approach, the younger worker has a longer period of time over which to accrue interest credits on the pay-based credits received early in his career. For example, suppose a 25 year old participant and a 50 year old participant (who have the same compensation) each receive a pay credit equal to 5 percent of compensation in 1999; at age 65, this pay credit will have a higher nominal value for the younger participant because it has a longer period of time over which to earn interest credits when interest credits are projected to age 65 (assuming that both participants take complete distributions at age 65 and not prior to that time).

   Furthermore, when cash balance accounts are converted to annuities commencing at normal retirement age, in many cash balance plans the increases in the annuity beginning at normal retirement age decline as a participant grow older. This decreasing normal retirement age annuity results primarily from the frontloading of interest credits as required by Notice 96-8, and is heavily dependent on the actuarial assumptions selected. With a different assumption as to salary increases, a low normal retirement age, or age-weighted pay based credits, the annuity at normal retirement age might not decrease, depending on the values and assumptions used. Even though the declining annuity at normal retirement age is not an inherent feature of cash balance plans, as different patterns of pay-based credits or interest credits or a different assumption as to salary increases or normal retirement age could eliminate the effect, the declining annuity has been the focus of the age discrimination analysis.

2. Analysis

   1. Application of section 411(b)(1)(H) of the Code

   1. Normal Retirement Age as Years to Payment

      A critical element of all defined benefit plans is an assumed payment date, which under the Code, is the normal retirement date. It is the combination of the use of a normal retirement date and the method of accruing interest credits to comply with the anti-backloading requirements that leads to the concern that interest credits are discriminatory.

      For example, in the case of a 45-year old employee, Notice 96-8 requires that a cash balance plan must project forward the interest credit earned for the plan year
to calculate the incremental portion of the normal retirement age (assume it is age 65) annuity that the 45-year old accrues for that year. If the plan does the same calculation for a 55-year old employee, the interest will be projected forward only 10 years (compared to 20 years for the 45-year old), and the incremental annuity earned by that older employee will look smaller than the incremental annuity earned by the younger employee. However, the calculations being compared are not the same. The 45-year old employee's interest credits are being projected forward 20 years, but the 55-year old employee's interest credits are projected forward only 10 years. If the plan were to project the 55-year old's interest credits for the same time span as the 45-year old's (20 years to payment), the incremental annuity earned by the 55-year old would, because of his shorter life expectancy, be greater than that earned by the younger employee. Indeed, if interest credits are treated as accruing in the year to which they are actually credited, not only is the plan not discriminatory, the disparity in accrual rates so heavily favors older workers that the plan will not comply with the limits on backloading.

Comparisons of immediate annuities earned by employees of different ages yield a result that can be more accurately compared. If a plan were to take the annual hypothetical contribution for the 45-year old and calculate an annuity that would be payable immediately to that employee, the calculation would yield a benefit accrual that is properly comparable to the same calculation (for an immediate annuity) for a 55-year old. In fact, because of the shorter life expectancy of the 55-year old, his accrual for the year would be greater than the accrual for the 40-year old.

Comparisons of immediate lump sum amounts earned by these hypothetical employees underscore the conclusion that employees are not treated differently because of different ages. For example, the interest credits for the 45-year old will be projected forward for 20 years, but then discounted back in a plan with a safe harbor interest credit rate. In this example, the immediate lump sum amount for the 55-year old will never be less than that of the younger employee.

What these comparisons show is that age is not the reason that the younger employees appear to have higher accruals -- the key factor that makes the difference is the number of years to payment. Because pension plans must be designed taking into account an assumed payout date (normal retirement age), plans base their benefit accrual calculations on that date for all participants, regardless of age. This is completely consistent with the requirements of section 4(i)(8) of the ADEA, which recognizes the legitimacy of setting a normal retirement age in a pension plan. In addition, the Code and section 4(l)(1)(A) of the ADEA permit plans to provide for the attainment of a minimum age as a condition of eligibility for normal or early retirement benefits. These are statutory recognitions of the need for a pension plan to set a normal retirement age.

It is also important to note that if interest credits were not required to be frontloaded under Notice 96-8, the age 65 annuity would not have to decline. Because of the Service's interpretation of the anti-backloading rules, under most plans future interest credits accrue at the time that the underlying pay-based credit is made, even though the interest credits are not actually granted until future years conclude. Without Notice 96-8, interest credits would probably be considered to accrue ratably over time, as actual interest accrues. Accordingly, to the extent that the decline in the age 65 annuity results from the frontloading of interest credits, the declining age 65 annuity exists "because of" governmental interpretations of law, not "because of" age.
Moreover, most cash balance plans are designed to provide the participant with an account, and are communicated to participants as such. In such a plan, the age 65 annuity benefit is a mechanical device used to comply with Service regulations and positions, but it has no economic meaning where the interest credit rate and discount rate are the same (or within the Notice 96-8 safe harbor). The participant is simply entitled to the account. The declining age 65 annuity results in part from accruing the interest credits in the year the related pay credit is accrued, in an effort to comply with Notice 96-8. In the absence of the Notice, participants’ economic benefit would increase with age.

2. Rate of Accrual, not Rate of "Accrued Benefit"

Section 411(b)(1)(H) of the Code prohibits decreases in the "rate of an employee’s benefit accrual" because of age. This phrase is not defined in the Code and is not defined in the proposed regulations under section 411(b)(1)(H) of the Code or any other Service authority. Some have asserted that the phrase means something like "rate of increase in the employee’s accrued benefit," in which case the well-established definition of accrued benefit would apply. The "accumulated benefit" is defined in section 411(a)(7) of the Code as an annuity starting at normal retirement age. Even if the term "accumulated benefit" were improperly imported, it would still be unclear what "rate" would mean – does rate mean the accrued benefit expressed as a percentage of a participant’s compensation? Or does it mean the percentage increase over the prior year's annuity at normal retirement age? These questions highlight the fact that section 411(b)(1)(H) requires some degree of interpretation.

Given the differences in statutory language between sections 411(a)(7) and 411(b)(1)(H), the better view is that the "rate of an employee’s benefit accrual" means something different from an employee’s "accumulated benefit," which is expressed as a normal retirement age annuity for purposes of testing compliance with the vesting and backloading rules. Congress could have used the term "accumulated benefit," and did not do so. Therefore, the issue of what happens to the normal retirement age annuity when age increases is irrelevant for this purpose. Moreover, the reference to early retirement subsidies (which are not part of the accumulated benefit) in section 411(b)(1)(H)(v) would be unintelligible if the body of section 411(b)(1)(H) were in fact referring to the "accumulated benefit."

This interpretation squares with the existence of contributory defined benefit plans and variable annuity plans. The benefit formula of a contributory defined benefit plan is similar to cash balance plans, in that the formula requires the contribution of a fixed percentage of participant’s compensation upon which earnings are credited. These plans would violate section 411(b)(1)(H) if the rate of benefit accrual meant the rate of change in the normal retirement age annuity as a percentage of current compensation. While the Service has not issued formal guidance on indexed traditional defined benefit plans, it has a long history of guidance on variable annuity plans. Variable annuity plans comply with the definitely determinable benefit rule and the accrual rules on the basis of the annuity benefit accrued under the plan formula, without consideration of the future value of the increase in the benefit (unlike what happens under Notice 96-8 with the interest credit). Accordingly, alternative definitions of the "rate of accrual" under section 411(b)(1)(H) of the Code should be accommodated in deference to the Service’s positions on other types of benefit plans.
The proposed regulations under section 411(b)(1)(H) of the Code also appear to suggest that protected benefits, rights and features should be analyzed to determine whether the plan formula complies with section 411(b)(1)(H) of the Code. This approach would not be the case if only the "accrued benefit" were at issue. See Prop. Reg. § 1.411(b)-2(d). In a typical cash balance plan, older and younger employees generally receive the same set of rights and features and the same benefit formula. (Actually, in many cases, older employees receive higher pay-based credits because plan designs are weighted for service or a combination of age and service.) This set of rights and features includes a right that arises at the time an allocation of a pay credit is made to the participant's account – the right to have interest credited to his or her account in the future as service is performed and credited under the plan. Accordingly, the thinking behind proposed regulations would suggest that cash balance plans do not violate section 411(b)(1)(H) of the Code.

All plan documents must define an employee's rate of benefit accrual in order to determine a benefit, and using the plan document to define the "rate of benefit accrual" for purposes of section 411(b)(1)(H) would be consistent with the language of that Code section, which requires that "under the plan, ...the rate of an employee's benefit accrual" cannot be reduced. Using the plan document would enable plan sponsors to show that a typical cash balance plan design, which provides uniform pay-based credits, does not discriminate on the basis of age.

3. "Equal Cost" is Relevant

The age discrimination issue can also be analyzed from another perspective. If the cash balance plan design were measured against the "equal cost or equal benefit" requirement of section 4(f)(2)(B)(i) of the ADEA, the frontloading of interest credits and the calculation of single sum distributions would clearly be lawful. (This provision allows employers to take otherwise prohibited actions when they are observing the terms of a bona fide employee benefit plan, and where for each benefit or benefit package, the amount of benefit or cost incurred on behalf of an older worker is no less than that made or incurred on behalf of a younger worker.) Assuming that the hypothetical annual contribution to the hypothetical account is calculated on an age-neutral basis (such as a percentage of salary), the employer will meet the "equal cost" leg of this test. It is true, of course, that the ADEA includes more specific rules relating to pension plans, including the section 4(i)(1)(A) prohibition against reducing accruals because of age, and therefore, some practitioners believe that the "equal cost" analysis is not applicable to pension plans. However equal cost is relevant as a general principle of ADEA interpretation at the time section 411(b)(1)(H) was enacted, and there is no evidence that Congress intended to upset this general rule through enactment of its other changes to ADEA at that time.

2. Implications of Case Law

No court has yet decided how to read section 411(b)(1)(H) of the Code in light of Hazen Paper, and no court has yet examined the accrual of future interest credits under a cash balance plan against the requirements of the ADEA. However, the case law cited previously announced broadly applicable principles under the ADEA, and the analysis in those cases should be applicable under section 411(b)(1)(H) of the Code. Although compliance with section 4(i) of ADEA (including a parallel provision to section
411(b)(1)(H) under ADEA) technically may be the exclusive means of complying with ADEA for defined benefit plan accruals, interpretations of that section should be consistent with other case law interpreting ADEA. Otherwise, an anomalous situation could result under which a plan could comply with broad age discrimination rules and fail to comply with a rule that was intended to clarify such principles.

As indicated above in the discussion of case law, a finding of age discrimination requires a finding of specific intent to discriminate against older workers. The language of section 411(b)(1)(H) on its face requires that only intentional discrimination be prohibited; under that Code section accruals must decrease "because of age." As previously described, courts have generally interpreted this "because of age" requirement to mean intentional discrimination only. Legislative history (the Conference Report cited at Footnote 6) also states that the new statute requires that "... a defined benefit plan may not provide that ... the rate of an employee's benefit accrual or contribution is reduced solely because of the employee's age before the employee accrues the maximum normal retirement benefit under the plan." The Proposed Treasury Regulations also support this interpretation, as they state that a violation of section 411(b)(1)(H) does not occur "solely" because of a positive correlation between increased age and a reduction in benefit accruals. Prop. Reg. § 1.411(b)-2(a).

Accordingly, we believe that section 411(b)(1)(H) is a prohibition of disparate treatment, which requires a finding of intent to discriminate. As explained previously, there are numerous legitimate business reasons that are unrelated to age for which plan sponsors adopt cash balance plans. A finding that cash balance plans violate section 411(b)(1)(H) would nullify and disregard the business purposes offered by employers for their conduct.

There is useful post- Hazen Paper authority in another pension design context, which suggests that, as in Hazen Paper, where there is a non-age related reason for applicable distinctions, an age discrimination claim should be rejected, whether under a disparate treatment or disparate impact theory. In Lyon v. Ohio Education Association, 53 F.3d 135 (6th Cir. 1995), the Sixth Circuit approved an early retirement incentive plan in a collective bargaining contract imputing additional service for employees retiring before normal retirement age, even though younger employees with the same length of service as older employees ended up receiving higher pensions. The court rejected the claim that the additional service rules penalized older workers because of age. It concluded, instead, that the disparity merely reflected the actuarial reality that employees who start work early in their career accumulate more years of service by the time they reach normal retirement age of 62. The court also observed that the difference in retirement benefits would be identical to the disparity that would exist if young and old employees worked until normal retirement age.

The dispute centered on the "Option B" early retirement benefit, described as follows:

Upon the earlier of the completion of twenty (20) years of service or the attainment of age sixty (60) after five (5) years of service, a participant may elect to retire. Early retirement under this Option B may be elected by the participant at any time after the participant meets the eligibility requirement. . . . early retirement benefits under this Option B shall be at least equal to the same percent of salary that the participant would have received if the participant had retired on the normal retirement date.

The plan permitted normal retirement at the earlier of age 62 or 32 years of service, and calculated monthly benefit levels by multiplying years of service by two percent of average monthly compensation.
The key point in Lyon that is applicable to the cash balance plan analysis is that the incentive program tied the benefit improvements to normal retirement age, just as future interest credits are projected to normal retirement age under a cash balance plan. Under the program in Lyon, Option B assumed that early retirees would have worked until age 62, requiring the imputation of the necessary years of service to each early retiree based on his present age. For example, if a 56 year old employee with 21 years of experience selected Option B, the plan treated him as if he had worked six additional years: the worker would receive $[(21 \text{ years worked}) + (62 - 56) \text{ years imputed}] \times 2 \text{ percent} = 54 \text{ percent of average monthly compensation}$. A younger employee with the same experience would receive a larger benefit: a 52 year old who had worked 21 years would receive $[(21 \text{ years worked}) + (62 - 52) \text{ years imputed}] \times 2 \text{ percent} = 62 \text{ percent of average monthly compensation}$. The net effect was to insure early retirees the same benefits under Option B that they would have received had they continued to work until their normal retirement dates. The Sixth Circuit found that the incentive program did not pay older employees lower benefits because of age. Instead, the court found that the disparity was a product of the employees' length of service and their ages when they were originally hired. Because any disparity merely reflected the actuarial reality that employees who start at an early age accumulate more years of service in reaching the normal retirement age of 62, the plan did not violate the ADEA.

3. Comparison with Traditional Pension Plans

Benefits under final average pay plans may vary significantly because of age. In a final average pay plan, participants with the same service and compensation will accrue benefits at different rates, depending on their ages. Older workers will accrue benefits at greater rates than similarly situated younger workers, although the annuity benefit payable at normal retirement age for both workers is the same. This effect occurs between members of the age-protected class, in addition to occurring among other workers. Accordingly, a final average pay plan may be said to provide equivalent annuity benefits, but disparate values, related to age.

In contrast, a typical cash balance plan provides an age neutral value (or greater value on account of increasing age), but an annuity benefit payable at normal retirement age that decreases on account of age. Accordingly, a cash balance plan may be said to provide equivalent values regardless of a participant’s age, but disparate annuity benefits related to age.

Accordingly, one alternative that should be considered is the use of both types of tests for age discrimination, tailored to the design of the plan. A final average pay plan might be tested for age discrimination by looking at accruals of annuity benefits payable at normal retirement age, while a cash balance plan would be tested for age discrimination on the value of benefits accrued for each year of service.

Another way to analyze a cash balance plan is to consider it as an indexed traditional career average plan. A cash balance plan operates identically to a traditional career average plan that indexes benefits from the date of accrual to the date of distribution. The "indexing rate" for this traditional career average plan is the cash balance plan’s interest crediting rate. For example, a cash balance plan providing 10 percent compensation credits and using a fixed lump sum factor of 10 is simply another way of describing a 1 percent career average plan indexing benefits at the plan’s interest crediting rate. While not common (though more common in certain foreign countries),
traditional plans providing indexed benefits have existed for decades without anyone claiming that their benefit structure was discriminatory on account of age.

3. **Recommendation**
Service and Treasury should be able to conclude that the basic operation of the interest credit in cash balance plans does not violate section 411(b)(1)(H) of the Code for several reasons. Guidance should take into account the fact that younger workers tend to participate in cash balance plans for longer periods of time than older workers and have longer periods to accrue interest credits. Guidance should also account for the need for a defined benefit plan to have an assumed payment date (i.e. a normal retirement age), which is a construct of law and actuarial science and is not related to age. Guidance should also clarify the meaning of the critical phrase "rate of an employee’s benefit accrual." Under *Hazen Paper*, the Supreme Court requires a finding of no age discrimination even in disparate treatment cases where the employer’s action (here, the actuarial effect of projecting the account to age 65) is motivated by factors other than age, and guidance should allow for nondiscriminatory employer purposes in administering cash balance plans.

IV. Single Sum Distribution Issue

1. **Issue: Does the method of calculating the single sum distribution in a cash balance plan discriminate because of age in a prohibited manner?**
   Under Notice 96-8, cash balance plans that define the benefit as the account must convert the account to an annuity commencing at normal retirement age for purposes of complying with the accrual rules and for other specified purposes. Under this theory, when the cash balance plan pays a single sum benefit, that normal retirement age annuity must be converted to single sum benefit using the interest rate and mortality table prescribed by section 417(e) of the Code. Under the Notice, a cash balance plan cannot pay the account—what has been promised to the participant—unless the plan uses a "safe harbor" interest credit rate. If a plan sponsor uses an interest credit rate that exceeds the safe harbor rate, then Notice 96-8 provides that the plan cannot be a qualified plan, and an additional amount must be paid to participants in excess of the account (see analysis below for full explanation of the calculation of the additional amount and the consequences of a failure to pay such amount). Younger employees appear to benefit more than older employees in cases where single sum payments are made in excess of the account, and as a result, a concern has been raised that this effect is discrimination because of age.

   However, in fact, many cash balance plans are designed to pay the account to the participant and no more, and that expresses the basic promise made to the participant. Nonetheless, many plans adopted prior to Notice 96-8 offer or offered interest credits at rates in excess of what became the safe harbor rates, on the theory that the higher rates gave a greater benefit to participants. The higher rates better reflected what participants could earn in a short-term GIC fund in a savings plan; this similarity facilitated participant communications.

2. **Analysis**

   1. **Background**
   The Service used Notice 96-8 to address a common feature of cash balance plans—the single sum distribution of the hypothetical account balance after the employee’s
termination of employment. Under the Notice, it is not always appropriate simply to pay out the hypothetical account balance. The Service explained that the first step in calculating the amount of the distribution is to project the employee’s hypothetical account (including all future interest, consistent with the frontloading requirement) to normal retirement age. Next, under the Notice, the plan has to calculate the present value of that projected hypothetical account balance. For this purpose, the interest rate applicable under section 417(e) of the Code must be used.

A potential problem with paying out the account balance arises if the plan uses an interest rate for annual interest credits that is higher than the Code section 417(e) rate. In that event, calculation of the present value of the projected forward amount will produce a number that is higher than the hypothetical account balance. In the Notice, the Service used the example of a plan providing fixed interest credits of 8 percent per year at a time when the 417(e) rate is 6.5 percent. A 45-year old employee with a hypothetical account balance of $45,000 terminates employment and requests a single sum distribution. Projected forward with future interest credited at 8 percent, the $45,000 hypothetical balance becomes $209,743 at the employee’s normal retirement age. If that amount is then discounted back to age 45 at the 417(e) rate of 6.5 percent, the present value equals $59,524 -- far exceeding the hypothetical account balance of $45,000.

Thus, if the plan were simply to pay the employee his hypothetical account balance of $45,000, the Service would view it as an impermissible forfeiture of $14,524. This result is often referred to as the “whipsaw” effect of the project forward/discount back requirement, as the plan is “whipsawed” into paying more than promised to the employee. A related problem occurs if the interest rate used to project forward to normal retirement age is lower than the section 417(e) rate. In that situation, use of the higher rate on the "return trip" (the discount back to present value calculation) could result in a present value amount that is lower than the hypothetical account balance. To avoid an impermissible forfeiture of part of the accrued hypothetical account balance, the plan in that case would have to pay out the higher amount.

To address the need to relate the project forward interest rate to the 417(e) rate required for the discount back, Notice 96-8 went on to list a number of "safe harbor" interest credit rates. The list of permissible rates was designed to assure that the future interest credits could, without violating the benefit accrual rules of section 411 of the Code, be projected to normal retirement "using a rate no greater than the applicable interest rate under section 417(e)(3)." If a plan is amended to use an approved rate, it can make a single sum distribution in an amount equal to the hypothetical account balance without risking a violation of section 417(e) of the Code or an impermissible forfeiture under section 411(a) of the Code.

2. Analysis

The analysis of this "whipsaw" issue is similar to the analysis of the interest credit issue. In these project forward/discount back calculations, the younger employee receives a higher present value for his hypothetical account balance not because of his age, but because of the number of years he has to normal retirement age under the plan, which is not an age that is the same in every plan but rather is a proxy for presumed date of payment. The greater the number of years for interest to be credited forward, and then discounted back using the favorable interest rate of section 417(e) of the Code, the greater the present value amount will be.
Note, however, that if the interest rates used for the projecting forward and the
discounting back calculations are the same, the younger employee will not be
advantaged. Absent a disparity in interest rates, the calculation will not produce a
subsidy for the younger worker. As a result, under Hazen Paper, no disparate
treatment claim can be raised. Under Hazen Paper, unless an employer is mindful of
stereotypes or makes inaccurate and denigrating generalizations about age when
engaging in the particular conduct, such employer cannot be considered to discriminate
because of age under the ADEA. It is difficult to imagine an employer with that in mind
when it sets a high interest credit rate, given the fact that higher interest credit rates
tend to increase account balances for all employees on a uniform basis.
It is important to recognize that the only time a younger employee actually receives
more money from a cash balance plan than the money an otherwise identically-situated
older employee receives is when a single sum payment is made using a higher interest
rate for the projection forward portion of the calculation than is used in the discount
back portion of the calculation. If Notice 96-8 did not create a problem for the cash
balance plan that credits accounts using a higher interest rate than the 417(e) rate
when it tries to pay the account balance as a single sum payment, the age
discrimination issue some have raised would not arise. Under the Hazen
Paper analysis, therefore, the motivating factor in the employer’s behavior can also be
said to be government regulation, not age. Even where employers make distinctions on
the basis of age, employers are permitted to make distinctions on the basis of age as
long as there is a motivating factor other than age, and here, the motivating factor is a
need to comply with Notice 96-8.

As was suggested earlier in the discussion of the interest credit issue, if cash balance
plans were tested against the "equal cost or equal benefit" requirement of section
4(f)(2)(B)(i) of the ADEA, the calculation of single sum distributions would clearly be
lawful. As long as the hypothetical annual contribution to the hypothetical account is
calculated on an age-neutral basis, the employer will meet the "equal cost" leg of this
test.

3. **Recommendations**

The anomaly in some plans which results in the payment of single sums in excess of the
account is a function of Notice 96-8 and of years to assumed payment, not a function of
age. Accordingly, binding authority should be issued to clarify that this feature of cash
balance plans (where it exists) should not be considered discriminatory because of age.

One of the consequences of Notice 96-8 is that it provides a disincentive to plan sponsors
from giving participants better benefits by making the use of above-market interest rates
more expensive than they would be if the "up and back" calculation did not result in a lump
sum higher than the account balance. Ways of expanding the safe harbor interest rates
should be explored. In addition, if the principles announced in Notice 96-8 are to become
law, binding authority should be issued and should contain transition rules enabling
sponsors to shift from higher interest credit rates to safe harbor rates. Some plan sponsors
with older plans would be interested in amending plans to conform to Notice 96-8, but until
the safe harbors are finalized, it not clear what approach is appropriate.

V. **Basic Conversion Issue**

1. **Issue: Does a conversion of a final average pay defined benefit plan to a cash
balance plan discriminate because of age?**
Under a final average pay plan, participants tend to accrue a significant percentage of their benefits in their final few years of service. In a cash balance plan, the rate of accrual is more even over a participant’s career with an employer. As a result, some participants in traditional plans which convert to cash balance plans who stay with the employer sponsoring such a plan until retirement can end up with smaller benefits than they would have received if the plan had not converted to cash balance. Some participants’ expectations to benefits may be upset in the conversion. While many conversions have included generous transition provisions for participants most affected by the conversion, other conversions have offered no transition benefits. As a result, a concern has been raised by some that conversions might inherently discriminate against older workers because of age.

2. Analysis

Traditional final average pay plans provide for the accrual of a substantial portion of participants' benefits in their final years of service. This effect results from pay increases towards the end of a participant’s career as well as the effect of additional years of credited service under a final average pay formula. In contrast, cash balance plans intentionally provide for more level accruals over a participant’s career. The Society of Actuaries study cited at Footnote 4 provides ample evidence for the point that cash balance benefits are often better for participants with shorter periods of employment with an employer, while final average pay plans are often better for employees with longer periods of service with a single employer. To mitigate the effect of the transition to a more even accrual pattern, many employers have offered some type of transition benefits to some or all active participants, effectively allowing them to stay in the old plan. These additional benefits tend to be offered to some or all of the longer service workers, as these workers will often not have the opportunity to accumulate the more significant benefits available in the cash balance formula over a longer remaining time to presumed payment date.

These transition provisions vary from plan to plan, but at least three types are relatively common. One type involves giving additional pay credits to some group of longer service employees. Another involves keeping participants with long service and/or older participants in the old formula. Another transition involves allowing some or all participants to choose between staying in the old formula or moving to the new cash balance plan. Usually, some combination of age and service is used for eligibility for transition benefits, so that older longer service workers are eligible.

Conversions involve plan redesign considerations which may be motivated by numerous and varied reasons: a desire to reduce costs, to better align benefits design with a more mobile workforce, to offer a plan that is more easily communicated to workers, to provide a plan that easily accommodates acquired groups of employees, or other permissible reasons. Conversions do not inherently single out older workers for benefit reduction. Accordingly, under Hazen Paper, a disparate treatment claim would be inapplicable to the typical cash balance plan conversion. In fact, Hazen Paper was fundamentally a case about employees’ upset expectations regarding future benefit payments. An employer fired an employee a few weeks before he vested, and this employer action was held to be illegal under section 510 of ERISA but did not present an ADEA violation because the action was intended to reduce benefits, not reinforce a stereotype. As Justice O’Connor wrote, The decision [to fire the employee] would not be the result of inaccurate and denigrating generalizations about age, but would rather represent an accurate judgment about the employee—that he indeed is "close to vesting." 507 U.S. 604 at 612.
Conversions generally provide that the rate of benefit accrual for all workers will be based on a new uniform formula after a certain date; if the new cash balance formula complies with section 411(b)(1)(H) of the Code and if there are no issues with "wear-away" (see discussion below), then age discrimination concerns disparate impact – that an effect of the conversion is that older workers receive worse benefits than they would have had the plan remained in effect, and that they are injured more than similarly situated younger workers in this regard. As we have seen, a disparate impact theory should not be available in age discrimination cases. Conversions tend to have multiple business purposes, and courts have consistently ruled against plaintiffs in disparate impact cases where a valid business necessity exists for the employer policy or act.

The loss of expected benefits may have a greater impact on longer service workers (who may be also older workers), depending on the design of the conversion. If this impact were prohibited, no defined benefit plan could be terminated or have a reduction in future rates of accrual. To date, the United States has had a voluntary employer sponsored pension system, and protecting expectations in addition to protecting accrued benefits would be inconsistent with the entire legal framework of the voluntary system.

3. Recommendation

Current law would not support a regulation that would prohibit all conversions on the ground that any program that had an adverse impact on older workers is per se age discriminatory. As we have seen, prohibition of employer conduct on disparate treatment grounds requires proof of bad intent, and a regulation or other Service interpretation that would adopt a disparate impact theory would extend the law beyond its current scope. Accordingly, additional guidance from the applicable agencies should confirm that a conversion of a traditional final average pay plan to a cash balance plan is not, without more, discriminatory because of age.

VI. Optional Forms and Ancillary Benefits in Conversions

1. Issue: If optional forms and ancillary benefits are offered under the new formula, but a grandfathered group is ineligible for such features, does the plan design discriminate because of age?

Sometimes, employers converting plans to cash balance require some group of older longer service employees to remain in the prior plan and do not permit them to be eligible for the cash balance formula. Typically, these employers believe that these employees would most likely be adversely affected by an immediate change to the cash balance formula and would generally be better off under the old formula or reach this result de facto through grandfathering and providing the greater of the account or the old plan formula. However, cash balance formulas often provide for lump sum distributions which are unavailable in traditional plans, and often provide death benefits equal to 100 percent of the account payable to any beneficiary, whereas many final average pay plans provide a lesser death benefit payable only to spouses. One issue this structure raises is whether employees in the "protected" group are discriminated against because of age because they were not offered the lump sum option or the greater death benefit.

2. Analysis

Where the composition of the grandfathered group is not based solely on age (i.e., where there is a service requirement as well), it would seem that a disparate treatment concern
would not be present under Hazen Paper, and that the questions regarding whether a
disparate impact claim may be brought under ADEA would still be present.

Moreover, there are general non-age related reasons for limiting the new features to the
cash balance formula and not adding them to the final average pay plan as well. The
availability of lump sums in a cash balance plan is extremely common, but is less common
in a final average pay plan because of several drawbacks. Single sum distributions in final
average pay plans can be very sensitive to interest rates, and accordingly, participants can
find it very difficult to plan for retirement if this feature exists; moreover, employers find it
very difficult to explain the potentially significant changes in value that can occur as a result
of interest rate changes.

To avoid complaints about failing to grandfather participants who would have benefited from
such a provision, some employers have offered all or a group of participants the right to
remain under the old plan formula or convert to the new benefit structure. Although the
choice feature may raise other concerns, it would appear to eliminate many age
discrimination issues, provided that the consequences of participant choice were explained
adequately to each participant. It should be noted that the choice feature itself is possibly a
benefit, right, or feature which could be implicated in an age discrimination analysis; in the
most extreme analysis choice would have to be offered to every worker over age 40, unless
some service component were part of the eligibility criteria as well.

3. **Recommendation**

   Guidance should provide a "safe harbor" for defining grandfathered groups, such that if
   there is one significant non-age related element (such as service), no age discrimination
   would be present.

VII. "Wear-away" Issue

1. **Issue: Does the "wear-away effect" which can result from cash balance plan
   conversions discriminate because of age?**

   Under current law, qualified defined benefit plans may be amended to reduce the rate of
   future benefit accrual, provided that plan participants receive at least the benefit accrued to
   the date of the amendment. See section 411(d)(6) of the Code and section 204(g)(1) of
   ERISA. In conversions of final average pay plans to cash balance plans, plan sponsors
   must give participants, as a minimum benefit, the benefit accrued to the date of the
   conversion, including service and compensation up to the date of the amendment
   converting the plan. The sponsor must also offer all rights and features, including early
   retirement benefits and optional forms of benefit, associated with the accrued benefit to the
   extent required by section 411(d)(6) of the Code.

   Depending on the nature of the transition benefits and the new cash balance formula, some
   participants in some cash balance plans may receive no additional benefit accruals under
   the plan for some period of time. They will receive at least the benefit under the old formula
   until the new formula provides a greater benefit. This phenomenon has become known as
   the "wear-away" effect; this name results from the fact that as the new benefit becomes
greater than the old benefit, the new benefit will "wear-away" the benefit under the prior
   plan formula.

   There is an issue as to whether this effect discriminates impermissibly against older
   workers. As will be illustrated in the examples below, wear-away is a function of factors
   unrelated to age. Longer service, unexpectedly low interest rates, and higher accrued
benefits to the date of the change are all factors that create wear-away. The wear-away effect does not on its face make distinctions on the basis of age, but for example, any worker with greater accrued benefits is more likely to be affected by wear-away than workers with smaller benefits, and older workers in many plans are more likely to have greater accrued benefits than younger workers.

2. **Analysis**

The "wear-away" issue is presented in a number of common transition benefits, and is illustrated in the examples set forth below. The examples are based on the following facts:

**Common Facts.** Company X is converting its final pay defined benefit plan to a cash balance plan. The current final pay plan provides a benefit equal to 1 percent of final pay times service, payable at age 65. For employees retiring at age 55 with at least 25 years of service, the plan provides a subsidized early retirement benefit. The benefit is an unreduced pension at age 62 with a 3 percent per year reduction for each year prior to age 62 that the benefit commences, to age 55. Thus, for instance, an employee retiring at age 55 with 25 years of service would receive a benefit equal to 79 percent of the age 65 benefit.

The employer converts all participants to a cash balance plan with a uniform allocation rate of 5 percent of pay and interest credits based on current GATT rates, preserving the prior formula benefit only as a legal minimum. Every employee receives an opening balance equal to the present value of his age 65 accrued benefit. Present value is based on then-current GATT rates, which are GAM-83 and 5.5 percent interest. The value of the early retirement subsidy is not included in the opening balance. Annuities under the cash balance plan are determined by converting the account balance to an immediate annuity using then-applicable GATT rates.

1. **Issue 1: Basic Wear-away Problem**

Assuming that interest rates remain constant, the effect of this conversion methodology is that many longer service employees with the largest benefits under the prior plan may experience a "plateau" in their benefit when they attain early retirement age. The plateau results from the fact that the value of the frozen benefit under the prior plan formula will exceed the benefit under the cash balance plan. Thus, for some number of years, the employee will accrue no additional benefit.

**Example 1.** For example, assume an employee who is age 55 and has 25 years of service and thus is currently eligible for early retirement. The employee earns $50,000 currently. For this employee, it is projected that the prior plan frozen early retirement annuity benefit will exceed the cash balance annuity benefit payable at the same age unless the employee works to age 64. (Projections in the following chart are based on 4 percent salary growth and constant interest rates.)

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<th>Prior plan immediate annuity</th>
<th>Cash balance immediate annuity</th>
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<td>62</td>
<td>$12,500</td>
<td>$11,262</td>
</tr>
<tr>
<td>63</td>
<td>$12,500</td>
<td>$12,456</td>
</tr>
<tr>
<td>64</td>
<td>$12,500</td>
<td>$13,780</td>
</tr>
<tr>
<td>65</td>
<td>$12,500</td>
<td>$15,250</td>
</tr>
</tbody>
</table>

A younger employee, such as any employee under age 40 in this example is not projected to experience any plateau at early retirement age. Older employees are expected to experience such a plateau, particularly those with longer service. For instance, an employee who is 47 and who has 10 years of service at the time of conversion is not projected to experience any plateau, but a 47 year old with 20 years of service is projected to experience a plateau for about 4 years, from age 55 to age 59. Longer service employees are therefore more adversely impacted than shorter service employees at the same age.

Clearly, these wear-away periods do not exist "because of" the attainment of any age, as section 411(b)(1)(H) would require. Other factors exist, although some older employees with longer service may be adversely affected. *Hazen Paper* would preclude a finding of age discrimination in this context on general principles.

2. **Issue 2: More Generous Transition Benefits for Some Employees Within the Protected Group**

   **Example 2.** To avoid the plateau issues highlighted by Example 1, the employer decides to calculate opening balances so that they equal the present value of the accrued benefit payable at earliest retirement age. For example, if an employee is age 50 with 20 years of service, the employee’s earliest retirement age is 55. The employee’s opening balance would be the present value of his accrued benefit payable at age 55 with a 21 percent reduction.

   The effect of this transition approach is to enhance opening balances significantly over what they would be if the opening balance was simply converted as the present value of the age 65 accrued benefit, as under the transition approach expressed in Example 1. However, the additional value depends on an employee’s age, and to a lesser
degree, service. Age 65 employees receive no additional value in their opening balance since their earliest retirement age is age 65. Age 55 employees receive the highest additional value, because the early retirement subsidy is most valuable at age 55.

To illustrate, the following table shows the enhancement as the increase in the opening balance over the present value of the age 65 benefit for employees from ages 43 to 65, each with 25 years of service.

<table>
<thead>
<tr>
<th>Current age</th>
<th>Increase to opening balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>$0</td>
</tr>
<tr>
<td>63</td>
<td>$23,600</td>
</tr>
<tr>
<td>61</td>
<td>$39,900</td>
</tr>
<tr>
<td>59</td>
<td>$48,800</td>
</tr>
<tr>
<td>57</td>
<td>$55,000</td>
</tr>
<tr>
<td>55</td>
<td>$58,800</td>
</tr>
<tr>
<td>53</td>
<td>$52,500</td>
</tr>
<tr>
<td>51</td>
<td>$46,800</td>
</tr>
<tr>
<td>49</td>
<td>$41,900</td>
</tr>
<tr>
<td>47</td>
<td>$37,400</td>
</tr>
<tr>
<td>45</td>
<td>$33,500</td>
</tr>
<tr>
<td>43</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

To the extent that this differential is based solely on age, older employees—those in their 60s—may challenge the design on ADEA grounds on the theory that the younger employees are receiving higher enhancements than they are. However, this disparity results at least in part from differences in service as well. Furthermore, section 4(l)(6) of ADEA provides that a plan shall not be treated as failing to meet the prohibition on the reduction in the rate of benefit accruals described in section 4(l)(1) of ADEA solely
because the subsidized portion of any early retirement benefit is disregarded in determining benefit accruals. Thus, the statute focuses on the normal retirement benefit and not the subsidized benefit.

Often, companies will decide not to extend this type of enhancement to all employees. Instead, companies might extend the full enhancement to employees within 5 years of early retirement, and then provide a limited enhancement to younger employees within 5 to 15 years of early retirement, and no enhancement for employees more than 15 years from early retirement. For instance, the 49 year old might get 90 percent of the enhancement, the 45 year old 50 percent and the 41 year old 10 percent. This is related to early retirement age and is therefore correlated with age, but is primarily based on years to early retirement and is intended to help the most adversely impacted in the protected group. There should be no concern that this technique discriminates because of age, because supplying additional benefits to older workers should not be suspect, but if there are concerns regarding this type of approach, perhaps guidance should give it special approval.

3. **Issue 3: Interest Rate Differential Exacerbates Wear-Away**

   **Example 3.** Long-term interest rates in this example are currently 5.5 percent. The employer reasonably believes that they are historically low and that they will go higher. If the opening balance is set by calculating the present value of the age 65 benefit at 5.5 percent and then interest rates go up, the opening balance plus future interest will exceed the original accrued benefit (not counting any additional cash balance benefits). For instance, if an employee were to terminate immediately after the conversion and leave his money in the plan, and interest rates rose to 7 percent, his opening balance would grow at 7 percent and then would convert to a much higher annuity than he had the day before the conversion. So, he would end up with a much higher benefit even though he quit the day after the conversion.

   To avoid this windfall, the employer decides to set opening balances by discounting accrued benefits at the employer's best estimates of future interest rates. The employer reasonably believes that 7 percent is a reasonable estimate for future interest rates and therefore sets opening balances as the present value of an employee's accrued benefit using 7 percent.

   However, interest rates, at least in the next few years do not increase but instead remain at 5.5 percent. This causes a wear-away of an employee’s benefit, particularly the lump sum benefit. The lump sum minimum is the present value of the frozen accrued benefit under the old plan, calculated using 5.5 percent. For most employees in this example, the lump sum minimum will be larger than their cash balance benefit, even including the additional cash balance credits that have been earned in the interim. So, for most employees in this example, it will take a few years for the cash balance benefit to catch up to the legal minimum lump sum.

   Because this element of wear-away results in significant part from two factors which are unrelated to age—service and unforeseen interest rates under section 411(b)(1)(H) and Hazen Paper—this element of wear-away should not be considered age discriminatory under current law.

4. **Additional Comment**

   It should be noted that "wear-away" has been a common means of transitioning benefits in cases where future benefit accrual rates must be reduced by reason of
changes in law or other compliance-related reasons. This technique has been used since at least Rev. Rul. 81-12, 1981-2 C.B. 228, which addresses the effect of plan amendments made to freeze benefits to change certain actuarial factors. Some of the many examples in which Treasury has adopted “wear-away” as a permitted means of transitioning benefits are Treas. Reg. § 1.401(a)(4)-13(c)(4) (determining benefits eligible for compliance with the nondiscrimination rules under a “fresh start” date); Treas. Reg. § 1.401(a)(17)-1(e)(5) (example 1 permits the “wear away” of the existing accrued benefit to facilitate compliance with the limits on pensionable compensation of section 401(a)(17) of the Code); and Rev. Rul. 98-1, 1998-2 I.R.B. 5 (facilitation of compliance with the changes to section 415(b) of the Code brought about by the Retirement Protection Act of 1994). These examples suggest that wear-away is consistent with the fundamental promise made to all employees regardless of age – that benefits accrued to date cannot be taken away by plan amendment or otherwise, but that employers have the right to amend plans to change future accruals. Moreover, these permitted wear-aways are likely to have the same disparate impacts on older employees as the wear-aways created by some cash balance conversions.

It should also be noted that the wear-away issue may have been addressed in the section 401(a)(4) regulations. If the wear-away issue is analyzed by looking at the cash balance plan as a "new" plan, then those participants with the "frozen" accrued benefit are receiving no accruals. This feature of a cash balance plan could have been viewed as discriminatory under the final section 401(a)(4) regulations; however, special rules were provided in the regulations to avoid this issue. Treas. Reg. § 1.401(a)(4)-13(f).

3. **Recommendation**

Where wear-away results from or is exacerbated by factors unrelated to age, current law allows this technique. In real cases, it is impossible to determine that the wear-away results solely from age-related distinctions when other factors play such a significant role. To avoid the need to deal with issues relating to an employer’s intent, safe harbors should be established so that certain conversion techniques that fundamentally favor longer service workers would be protected. In any event, under section 411(b)(1)(H) and *Hazen Paper*, wear-away should be discriminatory only if improper intent were established. As a result, if the Service or the Treasury determines that wear-away should be curtailed generally, legislation would be the preferred approach for so doing.
Footnotes

1 Sections 3(34) and 3(35) of ERISA; sections 414(i) and 414(j) of the Code.


4 For a full factual analysis of which groups of employees have benefited and which employees have been disadvantaged in cash balance plan conversions, see the Society of Actuaries study on cash balance conversions in the October 1998 issue of The Pension Forum, Kopp and Sher, "A Benefit Value Comparison of a Cash Balance Plan with a Traditional Final Average Pay defined-Benefit Plan."

5 Section 4(i)(7) of the ADEA provides:

   Any regulations prescribed by the Secretary of the Treasury pursuant to clause (v) of section 411(b)(1)(H) of Title 26 and subparagraphs (C) and (D) of section 411(b)(2) of Title 26 shall apply with respect to the requirements of this subsection in the same manner and to the same extent as such regulations apply with respect to the requirements of such sections 411(b)(1)(H) and 411(b)(2).

6 For example, "[u]nder 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….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." H.R. Conf. Rep. No. 1012, 99th Cong., 2d Sess. 376, 379.


8 See Section II.C.5.a hereof for a detailed explanation of Hazen Paper.

9 Society of Actuaries Study, cited at footnote 4.
A participant who is age 40 could also be affected by wear away on his or her accrued benefit without regard to early retirement subsidies, but this example does not illustrate that scenario.