Coalition to Preserve the Defined Benefit System

Comment on Proposed
Age Discrimination Regulations

March 13, 2003

Executive Summary

The Coalition to Preserve the Defined Benefit System is hereby submitting comments on the proposed regulations published by the Internal Revenue Service (IRS) on December 11, 2002 relating to the age discrimination rules under sections 411(b)(1)(H) and 411(b)(2) of the Internal Revenue Code (Code) and testing amounts of benefits under section 401(a)(4) of the Code.

We agree with the many comments already submitted that the proposed regulations are inconsistent with ERISA, the Code, Congressional intent and judicial decisions. Rather than repeating those comments, we will primarily focus on the problems the proposed regulations cause for most defined benefit plans and the appropriate standard that should be adopted to prevent true age discrimination.

We applaud the position taken in the proposed regulations that cash balance plans are not inherently age discriminatory, as some critics have claimed. The special exception for cash balance plans allows such plans to comply with the age discrimination rules by using defined contribution standards. But the general rule stated in the proposed regulations, and many of the other specific provisions for determining age discrimination, create other problems for certain cash balance designs, all pension equity plans (PEPs), most cash balance conversions, and various other retirement plan design approaches.

To address concerns with the proposed regulations, a group of employers has formed a coalition, with the assistance of Watson Wyatt Worldwide, of organizations ranging from small not-for-profit organizations to large corporations. This group of employers is called the Coalition to Preserve the Defined Benefit System, and its mission is to (1) make the regulations more inclusive of varying defined benefit plan design, (2) eliminate the specific obstacles they pose for cash balance and other innovative defined benefit plans, and (3) make clear that pension equity plans fully satisfy the age discrimination requirements.

To effect change in the proposed regulations, the Coalition is providing these comments and would like the opportunity to testify before the Treasury Department and IRS at the public hearing on the proposed regulations scheduled on April 9, 2003.

How the Proposed Regulations are Flawed

Although the regulations are well-intended, they will result in a number of negative consequences that will disrupt the defined benefit system, as set forth below. The proposed regulations discourage sponsorship of defined benefit plans by imposing more onerous standards than apply to defined contribution plans, reducing the attractiveness of defined benefit plans in comparison to defined contribution plans. Public policy should encourage sponsorship of defined benefit plans, not discourage it.

Restrictive General Rule for Defined Benefit Plans

The rules apply a unique restrictive age-discrimination standard to all types of defined benefit plans that does not apply to defined contribution plans, forcing employers with defined benefit plans to spend ten times more on older employees than younger employees.

To appreciate this issue, one must have a basic understanding of the general rule under the proposed regulations for testing age discrimination in a defined benefit plan. Under the proposed general rule, one must compare the annual accruals of an annuity benefit payable at normal retirement age, typically 65, for workers at different ages. If a younger employee accrues an annuity starting at age 65 of 1 percent of final average pay, the older employee generally must also accrue as much or more (subject to exemptions such as service caps, etc.). The problem is that the cost of an annuity starting at age 65 can be more than ten times greater for a 65-year-old than for a 25-year-old. So the general rule for defined benefit plans, in effect, requires more than ten times the value be provided to a 65-year-old than to a 25-year-old to avoid age discrimination, as well as limiting benefits for the 25-year-old to one-tenth the value of the benefits provided the 65-year-old.

While most defined benefit plans are subject to this restrictive general rule, cash balance and defined contribution plans have a simpler standard under which the contribution at age 65 needs to be only the equivalent of the age 25 contribution rate, not ten times larger. If a defined benefit plan approach does not meet the specific cash balance safe harbor, and provides, for example, merely six times the benefit at age 65 than at age 25 (e.g., a pension equity plan), it fails. If the equal contribution approach is a fair standard for age discrimination for the 80 percent of all plans today that are defined contribution or cash balance, it is fair age discrimination standard for the remaining 20 percent of all retirement plans as well. Imposing a stricter standard on defined benefit plans that requires such a disproportionate value be provided older workers does not further a policy of encouraging defined benefit plan sponsorship.

Workplace rules should not require economic biases in favor of older workers anymore than younger workers. If two employees are equally productive, government regulations should not require a higher cost for one of them. By requiring that a significantly greater cost benefit be provided to older workers, the general rule in the proposed regulations changes the dynamics of the employment marketplace and creates inappropriate incentives.

Restrictive Standard for Plan Design and Plan Amendments

The regulations will restrict plan design and plan amendments and should be modified to be sufficiently flexible to support future innovation and the changing needs of the workforce.

We sometimes fail to realize that our retirement system in the United States has been very dynamic during its evolution, responding to the conditions and needs of employers and workers over the decades. As this system has evolved, however, a substantial body of regulations has grown up around it to control the operation of retirement plans. The net effect of these regulations has been to limit the dynamism of the pension system. But the labor markets (and the resulting pressures on pension design) continue to change because of forces outside the control of the regulatory environment. If pension regulations cannot be adapted to changing labor market conditions, they may limit the utility of pensions in meeting the needs of employers and workers, and may produce adverse macroeconomic effects as well.

The proposed regulations limit flexibility to design or amend pension plans to meet an employer's workforce needs in two key areas:

First, the proposed regulations tend to push plan design into two categories: (a) traditional defined benefit plans (e.g., a traditional final average pay plan) and (b) cash balance and defined contribution plans. This occurs because the general rule restricts defined benefit plans to plain vanilla traditional plans and the safe harbor allows cash balance and defined contribution plans to exist. As discussed earlier, nothing in the middle meets the restrictive rules. This will unnecessarily stall the evolution of the U.S. retirement system. Companies will be restricted from having defined benefit plans that meet the changing needs of the workforce and the company.

Second, the proposed regulations prohibit many plan amendments unless the new plan provision is simply "tacked" onto the prior plan terms without any transition, or the amendment uniformly increases or decreases future benefits provided to all employees. The main reason for this result is that the proposed regulations consider age discrimination exclusively under a year-by-year test. Such a test does not allow for improvements in the past, or favoritism of older workers over younger under the prior plan, to be taken into account in the current testing year.

Flexibility in plan design is one of the key advantages of a defined benefit plan over a defined contribution plan. If defined benefit plans are not allowed to adapt to changing needs of the workforce or the changing employer business environment, then employers are likely to find other approaches to deliver compensation, deferred or direct, to employees.

Administrative Complexity with Limited Value

The proposed regulations add significant administrative complexity to the defined benefit system that will add to the burden on those plans, with some of the added complexities having limited value.

The new regulations impose a general rule that requires complex testing of defined benefit plan accruals determined on an annual basis, new rules for traditional plans that do not suspend benefits after age 65, and revised testing standards to check if plans discriminate in favor of highly compensated employees. Some of these new testing requirements seem to have limited utility in assessing violations of the various principles.

For example, it is unclear why new discrimination tests on highly compensated employees for hybrid plans need to be promulgated when the current regulations do an effective job of limiting employers from providing excess benefits to highly compensated employees. The proposed changes to the general nondiscrimination test for cash balance plans impose significant new administrative restrictions on cash balance plans that can be demonstrated with a simple example.

Assume an employer sponsors a traditional defined benefit plan for participants, and adds a cash balance formula providing a 2 percent pay credit with interest, so that each participant benefits under both a traditional and cash balance formula. Simply by adding the cash balance element to the plan formula, the plan must meet certain stringent requirements in order to test for nondiscrimination in amount of benefits in the same way the plan has always tested. Even if the traditional plan formula was considered nondiscriminatory before the cash balance formula was added and the cash balance formula provides a uniform value for all participants, the plan's status under the nondiscrimination rules is either in jeopardy or made significantly more complicated.

In addition, there are specific rules for post-normal retirement age adjustments, which are likely to be different than the procedures in place for the vast majority of plans that do not provide participants with a suspension of benefits notice. The proposed age discrimination regulations would impose a completely different methodology for determining the actuarial adjustment of benefits for post-normal retirement age service. Though the proposed regulations would require significant changes to plan's administrative procedures, it is not clear there would be any significant difference in benefits payable to late retirees.

For both of these issues, there is no clear policy reason for imposing new administrative procedures on pension plans without a clear directive that current procedures inadequately protect participants' rights.

Suggested Changes to the Regulations:

The Coalition believes that three significant changes need to be made to the proposed regulations.

- Age discrimination for ALL plans should be tested on the same basis. There should not be a second, tougher rule that applies to only 20 percent of plans. A pattern of benefit accruals is either discriminatory or it is not; it should not require ten times the value for a 65-year-old as for a 25-year-old in order to comply. That simply isn't fair.

  Testing for age discrimination can be accomplished by either reviewing the textual components of the plan formula to see if the rate of accrual under the formula declines with age, or by modifying the computational general test in the proposed regulations to consider the economic value of the benefit, not the age 65 benefit. In other words, use either a facial nondiscrimination test or create a mathematical test that considers the impact of the time value of money, combined with an anti-abuse provision to prevent inappropriate benefit formulas, to assess whether a plan is age discriminatory.

- In addition, the proposed regulations must improve their treatment of plan amendments that change from one complying formula to another, as well as increase flexibility for plan benefits offset against another plan.

  We feel this can be accomplished by testing the formula using an averaging approach that determines the benefit as a percentage of the employee's total service with the employer, as opposed to the year-by-year test currently proposed in the regulations, and to consider the gross benefit when applying the averaging test, not the net benefit. This averaging approach, similar to the "accrued-to-date" rules for determining accrual rates for nondiscriminatory amounts testing, would also be applied to test whether a conversion from a traditional plan to hybrid plan is age discriminatory.

- Avoid overburdening the defined benefit system with unnecessary new rules. This can be accomplished by withdrawing the proposed new comparability rules for cash balance plans, and keeping the existing rules on how benefits are delivered to employees older than the plan's normal retirement age that do not suspend benefits or offset for in-service distributions.

With these suggested changes, many plans that have never been questioned in the past, such as pension equity plans, will again be considered nondiscriminatory with respect to age and benefit amounts. The defined benefit system will be allowed to continue and operate under reasonable rules for assessing age discrimination in a pension plan that uses the same standard for all plans.

The remainder of this document will address, in greater detail, the problems with the regulation, expected consequences of its adoption in present form, and the Coalition's suggested solutions. We will focus on four key areas: the general rule, conversions from a traditional plan to a hybrid plan, the nondiscrimination in amount of benefit rules, and post-normal retirement age adjustments.

Introduction

This comment is submitted by the Coalition to Preserve the Defined Benefit System, a group of more than 50 employers that sponsor pension equity, cash balance and other defined benefit plans that benefit well over one million participants. Member companies range in size from small organizations to some of the largest corporations in the U.S., all of whom are concerned about the potential consequences of the proposed regulations on retirement plan operation, design and innovation, and on participant benefit security. Coalition members sponsor defined benefit plans covering more than 1,000,000 participants. Watson Wyatt Worldwide, a human capital and benefits consulting firm headquartered in Washington, D.C., helped organize the Coalition and is coordinating its efforts.

The Coalition members represent a broad spectrum of business interests reflecting different aspects of the U.S. economy and different regions of the country. They are united, however, in their common concern regarding the proposed regulations and the belief that both the importance of and risks to a strong defined benefit system have never been greater. Coalition members include Aetna, Inc.; Alliant Techsystems, Inc.; Amerisure Mutual Insurance Company; Belden Inc.; BlueCross BlueShield of Minnesota; Canadian Imperial Bank of Commerce (CIBC); Caterpillar Inc.; Cooper Industries; Cooper Tire & Rubber; Dial Corporation; The Dow Chemical Company; EDS; Fortis, Inc.; Fortune Brands, Inc.; Hughes Electronics; IBM; Illinois Tool Works Inc.; Memorial Hermann Health System; MidAmerican Energy; Oakwood Healthcare, Inc.; OGE Energy Corp.; Philips Electronics North America Corporation; Pitney Bowes; R.J. Reynolds Tobacco Holdings, Inc.; S&C Electric Company; Stora Enso North America Corp.; Sunoco, Inc.; Wells Fargo & Company; and WPS Resources Corporation. The Coalition would like to thank the Treasury Department and Internal Revenue Service for addressing the issue of age discrimination in pension plans, an issue of tremendous importance to both plan sponsors and participants. The Coalition also appreciates the opportunity to comment on the proposed regulations.

The proposed regulations are a crucial first step toward ending the IRS moratorium on determination letters for cash balance plan conversions and settling the issues surrounding cash balance plans, PEPs, and other hybrid plan designs. Coalition members believe the proposed regulations reflect the good intentions of regulators, but will pose difficulties for many pension plans and limit sponsors' ability to meet the needs of their employees. Significant modifications are needed to allow future innovation of plan design, protect participants against age discrimination, and help secure a critical source of retirement income for many working Americans.

Problems and Consequences of Proposed Regulations

We will now consider the problems and consequences of applying the proposed regulations to defined benefit plans. Issues have been classified into several different categories, including the restrictive nature of the proposed general rule in measuring the rate of benefit accrual, measuring the net benefit, and measuring the annual change in benefit accrual. We will also discuss the application of the proposed general rule to a plan using a PEP design.

Other sections of the following discussion will demonstrate problems in the proposed standards for converting a plan to a cash balance design and the complexities and difficulties inherent in the proposed changes to the nondiscrimination rules under section 401(a)(4) for cash balance plans. Finally, we will review the changes to how actuarial adjustments are made for participants accruing benefits after reaching normal retirement age.

General Rule is Too Restrictive

The proposed age discrimination regulations are well-intentioned and offer some long overdue and positive news for the employee benefits community, rejecting the charge that cash balance plans inherently violate age discrimination through the introduction of a specific cash balance safe harbor. Essentially all defined contribution plans are similarly blessed. However, in our opinion, the basic structure of the proposed regulations is flawed by the use of an overly restrictive general rule that applies to all defined benefit plan types that are not eligible for the cash balance exception.

The proposed general rule won't allow for continued evolution in plan design, frustrating sponsor's interest in maintaining plans that meet their business and workforce management needs. The U.S. private pension system has been remarkably innovative in its history, adapting to meet the changing needs of employers and workers. The proposed general rule effectively precludes future innovation in defined benefit plan design, forcing employers to adopt either a traditional defined benefit plan or a defined contribution/cash balance plan.

There are several limitations inherent in the proposed general rule, each deserving separate consideration. Significant issues and anomalous results are triggered by the general rule's limitation of measuring the rate of benefit accrual to the normal retirement benefit, the restriction on measuring benefit accrual on an annual basis, and the consideration of only the net benefit accrual under the plan. Each of these problems is discussed below in more detail, as is the impact of these rules on PEPs.

Measuring the Rate of Benefit Accrual

Current law indicates age discrimination in a pension plan is determined by whether the "rate of benefit accrual" declines or ceases on account of age. The phrase "rate of benefit accrual" is broad and subject to multiple interpretations. Instead of considering a variety of standards, however, the general rule in the proposed regulations measures age discrimination for defined benefit plans using only one measure — the rate of accrual of a participant's normal retirement benefit.

Defined contribution plans continue to comply with the age discrimination requirements because the proposed regulations look at the comparative contributions for younger and older participants. If the current year individual contribution rate for older employees equals or exceeds the rate for younger employees, the plan passes. For example, if younger employees receive a 2 percent of pay contribution, older employees, quite simply, must also receive 2 percent or more. This structure is generally followed in today's defined contribution plans. The safe harbor rules for cash balance plans are essentially the same as for defined contribution plans in this regard.

The general rule for defined benefit plans, however, compares the accruals of an annuity at normal retirement age, typically 65, for workers at different ages. For example, if it were not for the special cash balance exception, a plan providing a uniform 5 percent pay credit to all employees would have vastly different rates of benefit accrual for a 65-year old participant than for a 25-year old participant. For a 65-year old participant with annual compensation of $50,000, a 5 percent pay credit is worth $2,500 at normal retirement age, since the participant has already attained normal retirement age and the pay credit therefore is not increased for interest. A 25-year old participant with annual compensation of $50,000, on the other hand, has the same $2,500 pay credit increased for interest for 40 years, resulting in a value at normal retirement age of over $24,000, assuming 6 percent interest.

Application of interest between crediting the pay credit and normal retirement age provides the participant with valuable protection against erosion of the purchasing power of the benefit due to inflation during his or her working career, reflects the time value of money, and does not discriminate on account of age. While the presence of the cash balance exception in the proposed regulations permits this plan to be considered non-age discriminatory, virtually every other type of plan design that considers the time value of money will fail the general rule in the proposed regulations.

Perhaps the most significant issue with the proposed regulations is this limitation of the general rule to considering only the accrual rate of the normal retirement benefit. The phrase "the rate of benefit accrual" in the statute is admittedly vague, and clearly does not mandate the standard used by the proposed regulations. Limiting the general rule to measuring only the rate of accrual of the normal retirement benefit not only cannot be supported by the terms of the statute or legislative history, it is inappropriate policy.

When indicating that the rate of accrual cannot decline on account of age, the law indicates that the "subsidized portion of any early retirement benefit" is disregarded. There would be no need for this provision if the age discrimination standard applied only to the normal retirement benefits under the plan, which by normal operation of the plan never includes an early retirement subsidy.[1] The approach adopted in the proposed regulation thus violates an established principle of statutory construction by adopting an interpretation of the statute that causes one of the provisions of the statute to be superfluous.[2]

The legislative history of the age discrimination standard for pension plans does not support limiting the measure to the normal retirement benefit. The relevant conference report contains an example of a plan providing participants a flat dollar accrual of a $10 per month annuity benefit for each year of service, so that a participant who retires with ten years of service is entitled to a monthly annuity of $100. The example indicates that providing the participant with the same $10 accrual after attaining normal retirement age complies with the law, which is inconsistent with limiting the age discrimination measure to the normal retirement benefit. If the normal retirement benefit is the only measure, the

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[1] *See Laurenzano v. Blue Cross & Blue Shield of Mass., Inc.*, 134 F. Supp. 2d 189, 201 (D. Mass. 2001).

[2] *See TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) ("It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant. . . . We are reluctant to treat statutory terms as surplusage in any setting . . .") (internal quotation marks and citations omitted).

$10 accrual would need to increase for participants who have attained normal retirement age.

There are a variety of ways to measure the "rate of benefit accrual," and the proposed regulations reflect that, but only to a limited extent. In addition to the increase in the normal retirement benefit, the rate of benefit accrual could consider the immediate benefit or annuity, the economic or present value of benefits, or the formula benefit under the terms of the plan. The proposed regulations tacitly acknowledge this by switching from measuring the normal retirement benefit to measuring the immediate benefit for participants who have attained normal retirement age. However, this change in measurement does not appear to be recognition of different standards so much as a device to avoid requiring accrual rate increases for post-normal retirement age participants.

Measuring only the accrual rate of the normal retirement benefit adversely affects a variety of other plan designs, generally those that index or increase benefit accruals before retirement to reflect cost of living increases, mandatory interest, or a variety of other economic factors.

An example of a traditional plan that fails the proposed general rule is a contributory plan. Certain plans require employees to make after-tax contributions in order to accrue a benefit under the plan. Plans with such mandatory employee contributions must provide interest on the employee contributions at a specified statutory rate, and the accumulated employee contributions must be payable as an annuity if the value is greater than the formula benefit under the plan. The increase in accumulated employee contributions in many ways operates similarly to a cash balance plan.

A plan with mandatory employee contributions can not satisfy either the general rule or fit within the special cash balance exception. Since the accrual of employee-derived benefit operates so similarly to a cash balance plan, a contributory plan will fail the general rule for any period in which the participant's benefit is based on his or her contributions, rather than the employer-derived formula benefit. Even if the terms of the plan can be considered as providing a hypothetical account and reasonable interest rate, virtually no contributory plan defines the benefit based on employee contributions in terms of an immediate payment. Accordingly, a contributory plan does not fit within the cash balance plan exception.

Some other traditional defined benefit plans accrue benefits in terms of variable annuities, which provide benefits based on periodic payments that may vary in amount with investment experience, cost-of-living indices, or similar fluctuating criteria. Other traditional defined benefit plans accrue benefits based on the participant's career average pay, but index the benefits based on some variable economic criteria other than the participant's wage increases. The simple fact that a younger participant has a longer period of time for the annuity to vary based on economic criteria, or for the benefit to be indexed, results in higher normal retirement benefits than those earned by older participants. Employers have sponsored variable annuity and indexed career average plans for decades without any indication that such plans might be considered age discriminatory.

Finally, it is instructive to consider the application of the general rule outside the qualified plan arena, to determine whether measuring only the normal retirement benefit is an appropriate standard as a matter of policy. While Social Security benefits are not governed by age discrimination requirements, it is noteworthy that Primary Insurance Amount (PIA) benefits under Social Security would fail the general rule. Social Security PIA benefits are based on the average indexed monthly earnings, indexed to reflect increases in average wages and inflation before retirement. Such indexation results in a declining rate of benefit accrual as defined by the proposed regulations. Table 1 indicates the projected PIA benefits accrued during a year by workers of different ages. There is a clear decline in the annual accrual as the participant's age increases.

Table 1: PIA Benefits Payable at Social Security Normal Retirement Age for Workers by Age

Age	PIA Benefit at Beginning of Year	PIA Benefit at End of Year	Accrual Rate
25	$ 1,753	$ 1,917	2.37%
26	$ 1,701	$ 1,861	2.31%
27	$ 1,652	$ 1,807	2.24%
28	$ 1,604	$ 1,754	2.17%
29	$ 1,557	$ 1,703	2.11%
30	$ 1,512	$ 1,654	2.05%
31	$ 1,468	$ 1,605	1.98%
32	$ 1,425	$ 1,559	1.94%
33	$ 1,383	$ 1,513	1.88%
34	$ 1,343	$ 1,469	1.82%
35	$ 1,304	$ 1,426	1.76%
36	$ 1,266	$ 1,385	1.72%
37	$ 1,229	$ 1,344	1.66%
38	$ 1,193	$ 1,305	1.62%
39	$ 1,158	$ 1,267	1.58%
40	$ 1,125	$ 1,230	1.52%
41	$ 1,092	$ 1,194	1.47%
42	$ 1,060	$ 1,160	1.45%
43	$ 1,029	$ 1,126	1.40%
44	$ 1,000	$ 1,094	1.35%
45	$ 970	$ 1,061	1.31%
46	$ 942	$ 1,030	1.27%
47	$ 914	$ 1,000	1.24%
48	$ 887	$ 971	1.22%

49	$ 862	$ 942	1.15%
50	$ 837	$ 915	1.12%
51	$ 812	$ 888	1.10%
52	$ 788	$ 862	1.07%
53	$ 765	$ 837	1.04%
54	$ 743	$ 813	1.01%
55	$ 721	$ 789	0.98%
56	$ 701	$ 766	0.94%
57	$ 680	$ 744	0.93%
58	$ 660	$ 722	0.90%
59	$ 641	$ 701	0.87%
60	$ 622	$ 681	0.86%
61	$ 604	$ 661	0.82%
62	$ 586	$ 643	0.83%
63	$ 562	$ 619	0.84%
64	$ 546	$ 604	0.87%
65	$ 529	$ 587	0.87%

Source: Watson Wyatt. Workers are assumed to have 5 years of service at the end of the year and annual compensation of $60,000.

While there is no requirement that Social Security benefits satisfy the proposed regulations, a clear policy goal should exist that any age discrimination standards be flexible enough to allow the largest retirement income program for American workers to be considered nondiscriminatory. In short, these proposed regulations are unfairly restrictive and tend to push pension design into two buckets – traditional defined benefit or cash balance/defined contribution.

Measuring the Net Benefit

Another limitation of the proposed general rule is that each plan is tested on a separate basis, considering only the benefit payable from that plan. A plan that offsets for benefits earned under another plan, for example, is required to test under the proposed general rule on the net benefit, after reducing for the benefit provided by the other plan. Benefit offset arrangements are commonly sponsored to provide a coordinated benefit to participants, considering benefits provided by a defined contribution plan sponsored by the same employer, referred to as a floor offset arrangement. Other affected plan designs include a PIA offset plan, which provides benefits coordinated with Social Security benefits, and a variety of other practices where service and benefits may be coordinated with another plan sponsored by the same or a different employer.

Under a floor-offset arrangement, participants who have attained normal retirement age can have the amount of their account balance under the defined contribution plan increase faster than their gross accrual under the defined benefit plan, so that the "net" accrual is less than the net accrual for a younger employee. This fails the proposed general rule, even though there is no decline in the total benefit provided by the arrangement. A shift in the plans providing different portions of the benefit has occurred, but there's been no decline in the overall benefit provided the participant. By considering only the net benefit after the offset, this classic plan design is considered age discriminatory. This issue was the precise issue in controversy in *Lunn v. Montgomery Ward,*[3] which determined that the normal operation of a floor offset plan does not violate age discrimination standards, a position contrary to the proposed general rule.

Other plans coordinate benefits from the qualified plan with Social Security PIA benefits. The general objective of such a plan design is to provide combined benefits that constitute approximately the same percentage of the employee's income. While many plans have changed to so-called "permitted disparity" designs because of changes to the nondiscrimination standards under section 401(a)(4) of the Code, some plans still offset benefits directly for Social Security benefits. These plans, commonly referred to as "PIA offset plans," will commonly have larger offset for employees after attaining Social Security normal retirement age, as Social Security benefits are adjusted to reflect the date of commencement.

In addition to floor offset arrangements and PIA offset plans, there are a variety of other offsets common to pension plans, including offsets for prior employer plans, foreign public or private pension benefits, workers' compensation awards, and nonqualified deferred compensation amounts. The issues discussed above with regard to floor offset and PIA offset plans will occur, to some degree, in any plan that offsets benefits for amounts payable from another plan.

For example, assume an employer provides an acquired group of employees with a pension benefit based on all service, including service with their employer before the acquisition. If the prior employer's plan provides early retirement benefits at different rates than the new employer's plan, benefit accruals under the new employer's plan could be treated as declining on account of age. The generosity of the employer in providing the acquired employees any past service benefits results in the plan failing the age discrimination standard established by the proposed regulations.

Considering only the net accrual is inconsistent with many other rules applicable to qualified plans and long-standing Equal Employment and Opportunity Commission (EEOC) standards for determining whether other employee benefit practices discriminate on account of age. Prior IRS guidance permits floor offset plans to be tested under both the accrual rules[4] and the general nondiscrimination rules[5] based on the plan benefit prior to offset. Other provisions allow ignoring most other offset arrangements for nondiscrimination testing[6] and testing PIA offset plans or permitted disparity plans for

[3] 166 F.3d 880 (7th Cir. 1999).
[4] Rev. Rul. 76-259, 1976-2 CB 111
[5] Treas. Reg. 1.401(a)(4)-8(d)(1).
[6] Treas. Reg. 1.401(a)(4)-3(f)(9).

nondiscrimination by including an amount representing the PIA benefit.[7] EEOC regulations allow plans to determine cost data and benefit comparisons using a "benefits package" approach, [8] and courts have determined whether employee benefits do not discriminate on account of age if the value of total benefits under a coordinated program are nondiscriminatory.[9]

A variety of traditional and hybrid plans coordinate benefits with other qualified and nonqualified plans, a long-standing employee benefit practice that has never been considered age discriminatory. Due to the interaction of different plans, testing each plan only on the "net" benefit payable from that plan effectively prohibits a variety of standard plan designs and practices.

Measuring the Annual Change in Benefit Accrual for Hypothetical Participants

In addition to measuring only the accrual rate of the normal retirement benefit, the proposed regulations determine the accrual rate only on an annual basis, a restriction that limits a wide variety of appropriate benefit plan practices and precludes many types of plan amendments. Additionally, instead of looking at whether the rate of benefit accrual for an individual participant declines on account of age, the proposed regulations measure the benefit accrued during a plan year for two hypothetical participants who differ only by age. If the older hypothetical participant accrues a smaller benefit than the younger hypothetical participant, the plan is considered age discriminatory, regardless of whether there are any participants in the plan resembling the hypothetical participants.

The result of this test is that a wide variety of plan practices and designs that do not discriminate on account of age are treated as age discriminatory. (In certain situations, such as plan conversions, the test forces the plan to discriminate against participants on some other basis in order to avoid an age discrimination claim, an issue covered in more detail later). The annual measurement treats any preference for older workers in prior years as creating the potential for age discrimination in subsequent years.

For example, if a plan is amended to advance all participants over age 55 with three additional years of service under the plan's benefit formula, the plan will fail the general rule in the proposed regulations. Advancing participants' service increases accruals and is designed to encourage early retirement. By advancing the older workers years of service and therefore plan benefits, however, plan accrual rates for eligible participants will decline in following years. [10] Since only participants over age 55 receive the advance and experience the subsequent decline in accrual rates, the plan is considered age discriminatory under the proposed regulations. The overall effect of the plan amendment

[7] Treas. Reg. 1.401(a)(4)-7; 1.401(l)-1.
[8] EEOC Reg. 1625.10(d)(2).
[9] *Abanante v. Fulflex*, 701 F.Supp. 296 (D.R.I. 1988).
[10] O'Brien and Barker, *Cash Balance Plans: Are Wear-away Transitions Legal under the ADEA?,"* Benefits Law Journal, Spring 2000, Vol. 13, No. 1.

favors older participants, who receive accelerated accruals, but the proposed general test ultimately treats the plan as age discriminatory.

Alternatively, consider the amendment of a traditional pension plan that provides benefits integrated with Social Security to a traditional plan formula that is not integrated. Both types of formulas have been adopted by a larger number of employers and historically been viewed as nondiscriminatory on account of age. If the new plan formula is applied to all service, the additional accrual in the year following plan amendment will fail the proposed general rule. Accruals under the formula clearly should not be considered age discriminatory, but measuring accruals only an annual basis results in a standard type of plan change violating the proposed regulations.

Finally, consider a plan that provides continued accrual under the prior plan formula for a limited period of time to a select group of employees after the plan is converted to a hybrid design. Commonly referred to as "grandfathering" and generally considered a preferred transition method, providing continued accruals under the prior formula would be considered age discriminatory when the grandfathered participants ultimately cease accruals under the prior benefit formula. Providing any sort of minimum or grandfathered benefit for older workers inevitably violates the proposed general rule when the minimum benefit or grandfather formula no longer applies.

Pension plans are long-term mechanisms, both in terms of how benefits are earned and the employer's funding responsibility. Measuring accrual rates only on an annual basis and comparing two hypothetical participants ignores the history of the plan, which is integral to determining the overall value of benefits delivered to participants.

Impact on Pension Equity Plans

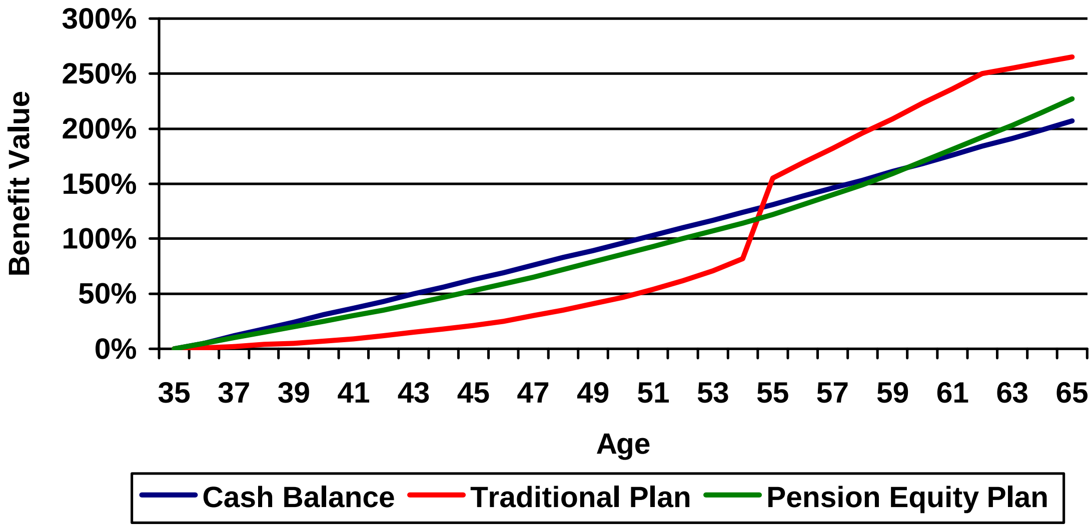
The only exception from the restrictive general rule is a special exception for cash balance plans. Noting that other hybrid plan designs will not be able to satisfy all the requirements for the cash balance exception, the preamble to the proposed regulations indicates the general rule would apply all other plans, which will tremendously limit the types of hybrid plans designs that will not be considered age discriminatory.

The PEP is among the most common of other hybrid plan designs. While PEPs and other hybrid plans may provide benefits to employees with similar age, service, and compensation histories as generous as cash balance plans, such plans will not be able to satisfy the restrictive general rule, whether plan benefits are stated as a uniform percentage of pay for all participants or a gradually increasing rate for older or longer service employees.

Pension equity plans typically define benefits in terms of a schedule of credits for each year of service. To determine his or her plan benefits, a participant totals the accumulated credits and multiplies this total by his or her final average pay. The resulting amount is defined in terms of a lump sum amount, which is converted to an annuity using specified assumptions or factors.

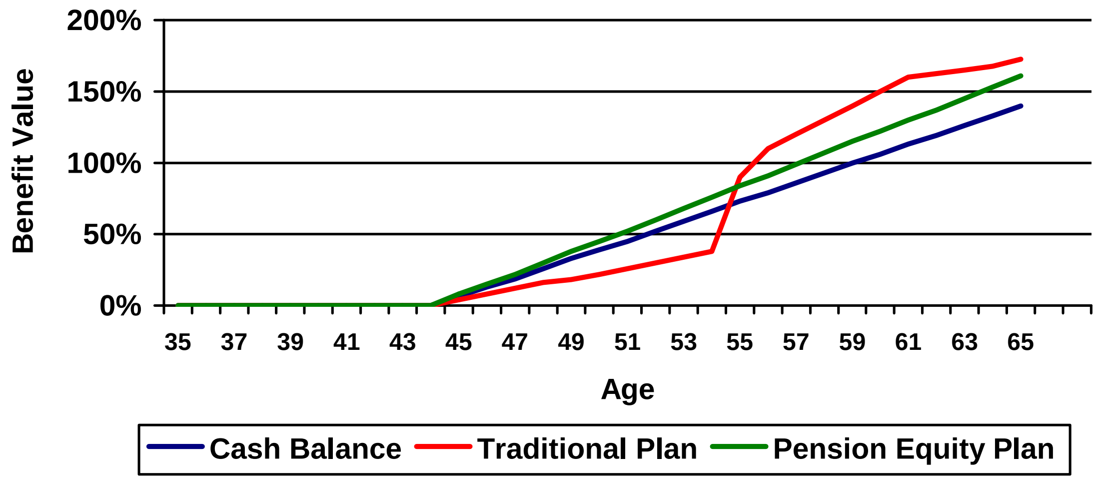
Many sponsors adopt PEPs in order to provide a benefit based on the participant's final average pay and more accurately provide for the participant's retirement income needs. PEPs are often considered a middle ground between traditional plans and cash balance plans, favoring younger workers more than a traditional plan and older workers more than a cash balance plan, as indicated by Chart 1.

Chart 1: Comparative Accrual Rates for Pension Equity, Cash Balance, and Traditional Defined Benefit Plans



PEP accrual patterns typically fall midway between the accrual patterns of cost-neutral traditional and cash balance plans because the majority of PEPs increase pay credits with age, providing more valuable benefits not only to older workers but also to employees hired in mid-career. If a PEP, cash balance and traditional plan are designed to be cost-neutral for a long-service employee, benefits provided under the PEP for a mid-career hire will more closely track the benefits provided by the traditional plan than benefits provided by the cash balance plan, as indicated by Chart 2.

Chart 2: Comparative Accrual Rates for Pension Equity, Cash Balance, and Traditional Defined Benefit Plans for Mid-career Hire



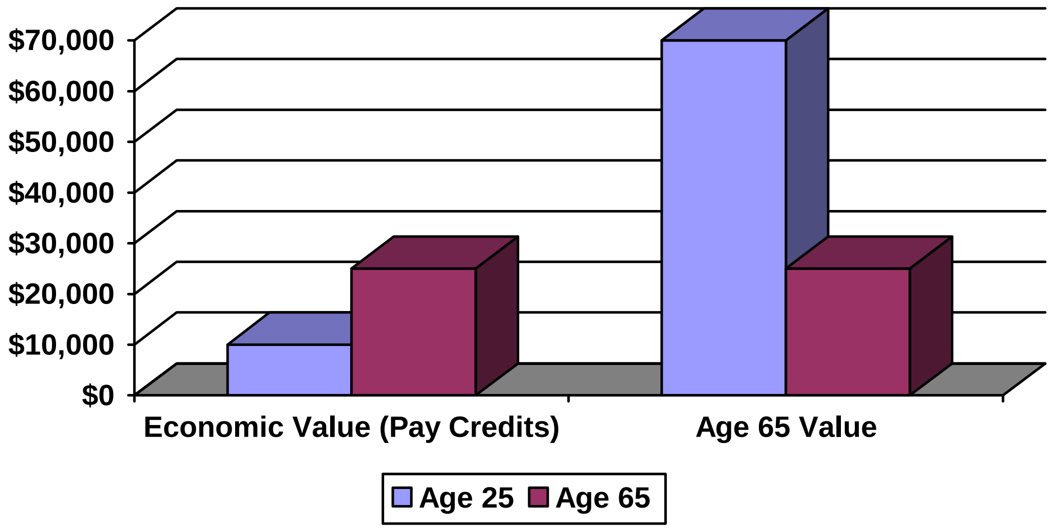
From a plan design perspective, PEPs are the likely vehicle to be considered by employers who wish to provide a benefit closer to traditional final average pay plans than cash balance plans. PEPs are also likely to be chosen over cash balance plans by employers who want to provide better benefits to older mid-career hires.

Despite the features of a PEP design that are clearly beneficial to participants across a wide demographic spectrum, PEPs would be considered age discriminatory under the proposed regulations. PEPs would not be eligible for the cash balance exception and generally would be unable to satisfy the restrictive general rule.

PEPs are not eligible for the cash balance exception because interest is not credited on a hypothetical account. Instead, PEPs multiply accumulated credits by the participant's final average pay. Therefore, identical cash balance and PEP formulas will produce the same accrual pattern if increases in an employee's salary equal the interest crediting rate for the cash balance plan. Even in that event, however, the cash balance plan would be able to satisfy the age discrimination standard while the PEP would be considered age discriminatory.

A PEP lump sum benefit will generally convert to a lower annuity benefit payable at normal retirement age for an older employee than for a younger employee (exactly the same result experienced by a cash balance plan) simply because the older employee has fewer years of pay increases factored into the annuity benefit at normal retirement age. So even though the vast majority of PEPs provide larger PEP credits for older workers, testing on the basis of normal retirement benefit will result in a declining accrual rate. This is illustrated by Chart 3, which shows the relative economic value and age 65 value for a PEP providing increasing credits for older workers. In this case the plan provides 4 percent credits for workers under age 30 and 10 percent credits for workers over age 45.

Chart 3: Application of Proposed General Age Discrimination Rule to Pension Equity Plan

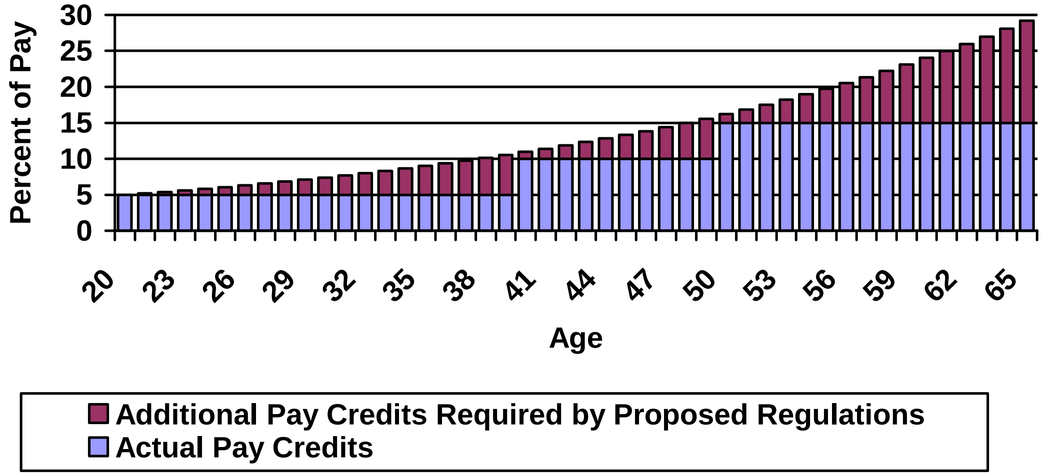


The proposed regulations create additional testing problems for PEPs because of the annual basis for determining accrual rates. Testing present value on an annual basis presents difficulties for PEPs simply because it is quite common to increase credits for older workers. As noted earlier, the vast majority of PEPs increase pay credits for older workers. The result is an increase in the rate of accruing either the normal retirement benefit or the present value of the participant's benefit. The increase in benefit that is attributable to a step up in pay credits will be greater than the increase in benefit the following year based on the accrual of pay credits at the higher rate.

For example, if a PEP increases pay credits from 5 percent to 10 percent when a participant attains age 45, the increase in the participant's rate of benefit accrual in the year of increase will be greater than the following year when the participant accrues another 10 percent pay credit. Testing only the annual increase in the participant's benefit, whether on the basis of normal retirement benefit or economic value, results in anomalous situations where plans that increase benefits on account of age are considered age discriminatory.

The combination of these testing requirements results in a testing standard that effectively requires annual increases in PEP credits. To illustrate, Chart 4 shows the actual pay credits offered by a PEP sponsored by a mid-size employer, and the adjustment necessary for the plan to satisfy the proposed regulations. The actual pay credits increase on account of age, providing older workers with pay credits three times the size of younger workers. In order to comply with the proposed regulations, however, the pay credits would need to increase each year, significantly increasing the complexity of plan administration, and essentially double the pay credits for older workers, significantly increasing the cost of maintaining the plan.

Chart 4: Minimum Required PEP Credits to Satisfy Proposed General Age Discrimination Rule



Viewing PEPs as age discriminatory in any way is counter-intuitive, especially when the accumulated economic value of PEP accruals is compared to cash balance pay and interest credits. A PEP should not have to sharply or annually increase credits so that the crediting rate for older workers is ten to thirteen times the rate for younger workers and the plan complies with an age discrimination standard, especially when a cash balance plan can maintain a uniform pay crediting rate and be considered nondiscriminatory. Whether a plan's formula or delivery of benefits is considered age discriminatory should not depend on whether the plan document describes interest credits and a hypothetical account.

Conversions

The proposed regulations also create new requirements for converting a traditional defined benefit plan to a cash balance plan. Not only are specified minimum benefits required in addition to the existing protection in ERISA for benefits already accrued, but any transition benefits provided to employees during the conversion are tested under a restrictive approach. The proposed regulations impose requirements for traditional plans converted to cash balance plans that don't exist when replacing a traditional defined benefit plan with a defined contribution plan. The proposed conversion rules also prevent many approaches for protecting participants during a conversion.

The process of converting a traditional defined benefit plan to a hybrid plan may be the most carefully considered step in the entire process of moving to the new plan, and certainly has been the most controversial aspect of the cash balance debate over the past several years. Cash balance critics have voiced opposition to certain plan conversions, generating adverse media attention surrounding these plans. Oddly, instead of permitting employers to provide various forms of transition benefits during a plan conversion, the proposed regulations severely restrict transition benefits protecting older workers' interests — exactly the opposite result of what government regulators should be seeking.

Restrictions on plan conversions in the proposed regulations will severely limit an employer's ability to provide appropriate transition benefits to participants during a conversion. Many plan sponsors have used one of two approaches to smooth the transition for older workers:

- Provide participants a benefit at transition equal to what they would have earned if the hybrid plan had always been in existence. This is entirely consistent with the typical approach used when amending the benefit formula in a traditional defined benefit plan.
- Reflect the value of early retirement subsidies in the initial hybrid plan benefit. For example, in a conversion to cash balance, the opening balance would be set equal to the present value of the immediate benefit rather than the present value of the benefit payable at normal retirement age.

The proposed age discrimination regulations would define such attempts to protect older workers as age discriminatory. The proposed age discrimination regulations require that amendments implementing hybrid conversions conform to one of two specific structures in order for the plan to satisfy the age discrimination standards:

- The plan provides benefits greater than or equal to the sum of the pre-conversion, traditional plan accrued benefits plus the benefits provided by the post-conversion cash balance hypothetical accounts, or
- The plan provides a benefit greater than or equal to the present value of the pre-conversion plan's accrued benefit plus the future service cash balance account.

A conversion under the second conversion technique described above must separately show that any benefits provided in excess of the minimum required conversion benefit meet the age discrimination requirements when treated as an addition to the participant's hypothetical account for that year. This sort of test is inconsistent with a variety of transition benefits intended to reflect the significant impact a plan conversion can have on a participant's ultimate retirement benefit.

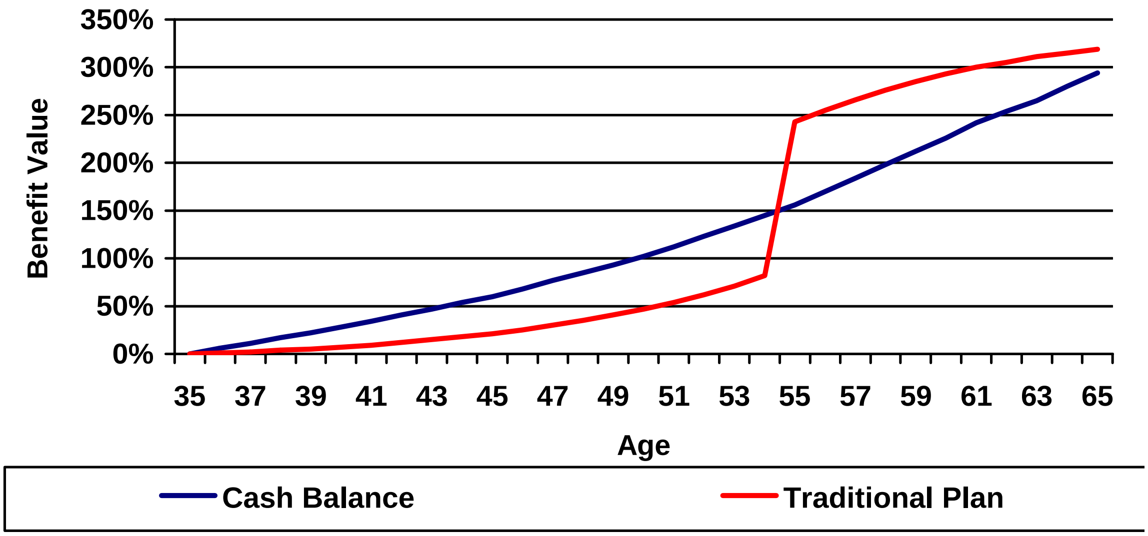
Transition to Hybrid Plan Designs

Hybrid plans have fundamentally different accrual patterns than traditional defined benefit plans. The focus is on building retirement savings and on providing portable benefits for the 85 to 90 percent of employees who change jobs multiple times during their careers. Hybrid plans build value steadily, often at the same pace for all participants.

Traditional defined benefit plans are designed to encourage career employment at a single employer and typically provide valuable incentives to retire early as a reward for long service. The focus is on providing retirement security for full-career employees. Consistent with this focus, most of the value provided by traditional defined plans is earned in the final few years immediately preceding retirement.

Chart 5 illustrates the accrual patterns for equal-cost cash balance and traditional defined benefit plans, where "Benefit Value" is defined as the lump sum value of the benefit divided by current salary at that age.

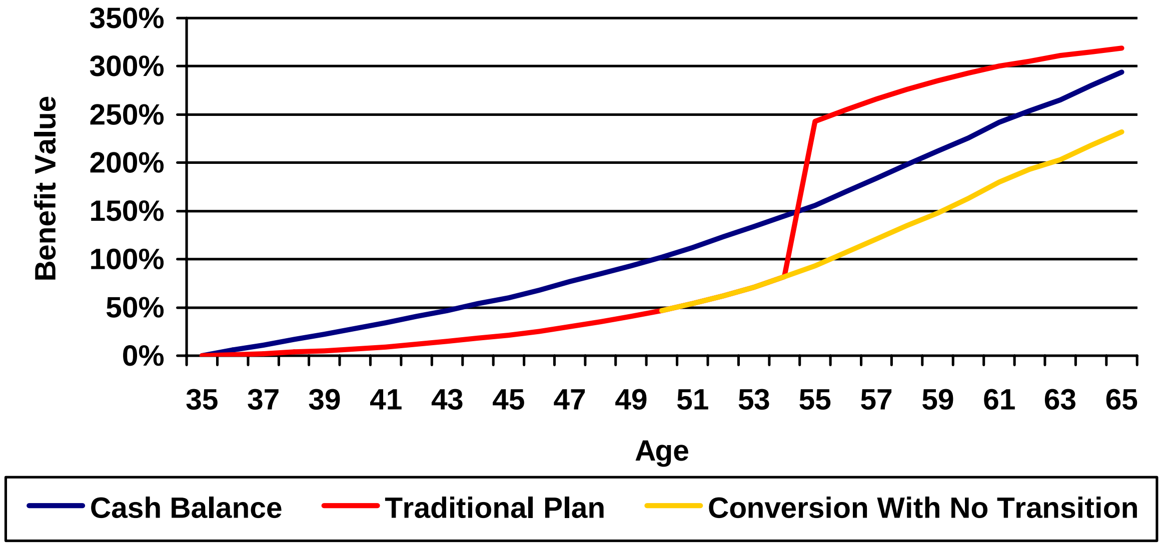
Chart 5: Accrual Patterns for Equal-Cost Cash Balance and Traditional Defined Benefit Plans



Employers converting from traditional defined benefit plans to cash balance typically include transition provisions to protect the retirement interests of mid-career employees. Otherwise, these employees would end up receiving less than they would from career-long participation in either plan.

Consider Chart 6, which depicts an employee hired at age 35 and covered under a traditional defined benefit plan until age 50, when the employer converted the plan to a cash balance plan. Without transition provisions, future increases in value will start with the participant's accrued benefit at date of conversion and increase according to the cash balance pattern. Participating in a traditional plan for the first half of the participant's career followed by cash balance for the remainder, without providing transition benefits, results in the employee receiving a much lower benefit than if all service had been reflected by one design or the other. This is the result required under the proposed regulations.

Chart 6: Equal Cost Traditional and Hybrid Plan, Effect of Transition on Mid-career Employee



Plan sponsors often decide to reflect the hybrid plan on a past service basis in order to prevent just this result. The proposed regulations support the conversion of a traditional defined benefit plan to a cash balance plan with no transition benefits, and consider application of the new cash balance formula to all service as age discrimination because employees at older ages would not receive as much of an increase in their accrued benefits. If the plan were converted to a cash balance plan when the participant in Chart 6 was age 57, for example, application of the cash balance formula to all service would provide no additional benefit.

A key basis for the precluding application of the cash balance formula to all service is the idea, present in both the general rule and the special rules for cash balance conversions, that accrual rates for two hypothetical participants are compared, and if the older hypothetical participant has a lower accrual rate, the plan discriminates on account of age. Comparing accrual rates of two hypothetical participants is a disparate impact analysis for determining the presence of age discrimination,[11] a theory of dubious application to age discrimination claims.[12] Age discrimination standards require neither

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[11] Actually, the comparison of hypothetical participants is more stringent than a disparate impact analysis, since it doesn't require any discriminatory impact on actual participants.

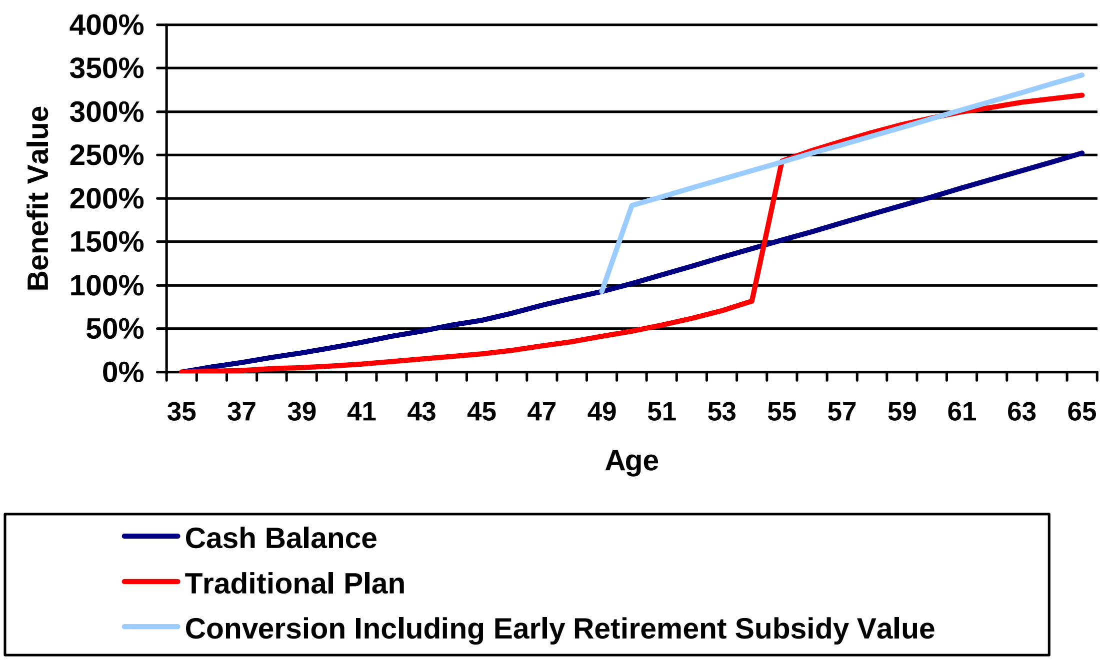
[12] *Hazen Paper Co. v. Biggins*, 507 U.S. 604, (1993); *Adams v. Florida Power Corp.*, 255 F.3d 1322 (11th Cir. 2001); *Gantt v. Wilson Sporting Goods Co.*, 143 F.3d 1042 (6th Cir. 1998*); Mullin v. Raytheon Co.*, 164 F.3d 696 (1st Cir. 1999*); Rhodes v. Guiberson Oil Tools*, 75 F.3d 989 (5th Cir. 1996); *Salvato v. Illinois Department of Human Rights*, 155 F.3d 922 (7th Cir. 1998); *Ellis v. United Airlines, Inc.*, 73 F.3d 999 (10th Cir. 1996).

favoring older workers over younger workers, nor preserving previous favoritism of older workers when benefits are changed.[13]

Comparing two hypothetical participants in a plan conversion as a standard for age discrimination requires the sponsor to discriminate against participants on another basis. Prohibiting application of the cash balance formula to all service results in two participants with the same amount of service at the same ages and at the same pay receiving different benefits, with the participant with all service under the cash balance formula usually receiving the larger benefit, and the participant with some service under the prior plan formula and some service under the cash balance formula usually receiving the smaller benefit. The sponsor is forced to discriminate against employees based on date of hire in order to avoid a claim of age discrimination.

Another transition concern illustrated by Chart 6 is the early retirement subsidy that would be provided to the 50-year-old participant upon the attainment of age 55. While the subsidy would continue to be provided on the traditional plan benefit that the participant has already accrued, five years of coverage under the cash balance plan might add little or nothing to the benefit payable at age 55. In order to remedy this problem, some plan sponsors have chosen to reflect the value of the traditional plan's early retirement subsidy in the opening balance under the hybrid plan. This is illustrated in Chart 7.

Chart 7: Equal-cost Traditional and Cash Balance Plans – Higher Opening Balance



[13] *Finnegan v. TWA*, 967 F.2d 1161 (7th Cir. 1992).

The proposed regulations would make the practice of reflecting early retirement subsidies in opening account balances age discriminatory because the value of an unreduced benefit is higher at younger ages. Thus, an opening balance that reflects the value of an unreduced benefit for a 60-year-old participant would be higher if the participant were younger.

The value of early retirement subsidies declines as a participant nears normal retirement age. Because of this result, early retirement subsidies would be considered age discriminatory if not for special exceptions in the law.[14] These exceptions recognize that while the mechanical operation of an early retirement subsidy might be characterized as age discriminatory, allowing employers to encourage the voluntary early retirement of workers should be permitted. For plans that offer early retirement subsidies, such provisions are often among the most favored plan features by plan participants. If early retirement subsidies represent an appropriate workforce management technique, an employer should be able to provide the value of those subsidies to participants upon a cash balance conversion.

Additionally, preventing employers from including the value of early retirement subsidies in conversions is another example of the proposed regulations inappropriately imposing stricter standards on defined benefit plans than on defined contribution plans. It would be perfectly acceptable to transition to a defined contribution plan by terminating the traditional defined benefit plan and distributing lump sums to participants reflecting the present value of immediate benefits that could then be rolled over into the defined contribution plan.

The proposed conversion rules set a standard so restrictive that it will be nearly impossible to provide several typical provisions frequently used in plan conversions to protect participants. Conversion benefits are limited to providing no transition benefits at all or only providing uniform or increasing benefits to every employee, which will inevitably result in some employees receiving too much and other employees receiving too little.

General Nondiscrimination in Benefit Amount Rules

Consistent with their status as defined benefit plans, cash balance plans are effectively always shown to comply with the nondiscrimination in contributions and benefits requirements by testing on a benefits basis. The procedures for nondiscrimination testing are well understood and broadly accepted as reasonable and effective. Plan sponsors have come to rely on these testing procedures in creating cash balance plans that accomplish a number of important workforce management objectives, including helping employees pay for medical benefits in retirement and encouraging employee savings, in addition to providing pension benefits. The proposed regulations impose new standards for testing cash balance plans under the general nondiscrimination standards that place

[14] Code §411(b)(1)(H)(iv); ADEA §4(l)(1)(A)(i).

enormous obstacles in the way of these objectives and reveal a puzzling hostility toward defined benefit plans relative to defined contribution plans.

Commonly referred to as the "new comparability" rules, the proposed standards impose elaborate and administratively burdensome requirements on cash balance plans in order to demonstrate that the plan provides nondiscriminatory benefits to highly and nonhighly compensated employees. Some plans that have always been considered nondiscriminatory may not be able to satisfy the cash balance new comparability rules and will not be able to test for nondiscrimination under alternate testing methods. At the very least, the proposed new comparability rules for cash balance plans are a significant increase in complexity for how such plans demonstrate that nondiscriminatory benefits are provided to highly and nonhighly compensated employees.

The cash balance new comparability rules establish new thresholds that plans including a cash balance formula must satisfy in order to perform nondiscriminatory amounts testing as a defined benefit plan. A plan providing benefits only under a cash balance formula must provide broadly available pay credits, have pay credits based on a gradual age or service schedule, or satisfy a minimum gateway test potentially requiring additional pay credits for nonhighly compensated employees. A plan providing benefits under both a cash balance formula and a traditional formula has an even more stringent requirement, and benefits under both formulas must satisfy combined minimum benefit and contribution threshold — referred to as the DB/DC gateway — in order to test as a single plan on a defined benefit plan basis.

The DB/DC gateway is a formidable hurdle for a plan providing benefits under both a traditional and cash balance formula, a design that can occur for a variety of reasons. Many employers have added a cash balance benefit to a traditional defined benefit plan so that each plan participant benefits under both formulas, with the cash balance formula intended to fund the participant's medical benefit premiums in retirement. Such a plan will almost certainly not be able to test the entire plan benefit on a benefits basis. The plan must meet the minimum gateway allocation for DB/DC plans by treating the cash balance pay credit as a defined contribution plan allocation. This is an extremely unlikely result unless the cash balance pay credit satisfies the gateway allocation on its own.

A particularly perverse result of the proposed regulations concerns one of the most publicized trends in pension plan re-design — the use of employee choice. A number of sponsors that converted a traditional defined benefit plan to a hybrid design gave employees a choice to remain in the traditional plan or migrate to the new design. Even though application of either plan formula is exclusively within the control of the employee, the presence of nonhighly compensated employees benefiting under the traditional plan will almost certainly result in failing the new comparability standards. As a result, employee choice is not going to be an approach employers take in plan conversions.

Plans that used other commonly favored transition techniques are also forced to satisfy difficult new standards as part of its nondiscriminatory amounts demonstration. A cash balance plan providing accruals to a grandfathered group under the prior traditional formula, either indefinitely or for a limited period of time, will find its ability to test as a defined benefit plan severely restricted and subject to complex new requirements, if available at all.

Finally, the proposed nondiscrimination standards for cash balance plans treat such plans as defined benefit plans for some purposes and as defined contribution plans for other purposes. Cash balance plans are treated as defined benefit plans for determining which gateway test applies, but they are treated as defined contribution plans by using pay credits as defined contribution allocations under the gateway test. Not only does this treatment not reflect a clear and consistent compliance scheme for cash balance plans, it can lead to situations where inappropriate incentives are created.

A cash balance plan that is combined with a traditional defined benefit plan must satisfy the DB/DC gateway test in order to test on a benefits basis — no other new comparability test is allowed. A cash balance plan that is aggregated with both a defined contribution plan and a traditional defined benefit plan, however, can use not only the DB/DC gateway test, but other tests that consider whether most nonhighly compensated employees benefit under the traditional defined benefit plan or whether each plan could separately satisfy minimum coverage standards. The presence of other new comparability tests increases the chances that the aggregated plan can be tested as a defined benefit plan. If an employer sponsors a cash balance plan that is combined with a traditional defined benefit plan and the combined plan cannot satisfy the gateway test, the proposed regulations create an incentive for the employer to sponsor a defined contribution plan, even one that provide de minimis allocations, in order to make other new comparability standards available.

It is not clear what potential abuse the proposed cash balance new comparability rules are addressing. During the entire cash balance controversy, there has not been any suggestion that cash balance plans inappropriately favor highly compensated employees. To the contrary, the normal pattern of benefit accrual under a cash balance plan generally favors nonhighly compensated employees more than a traditional defined benefit plan.

The new comparability standards for cash balance plans will impose new administrative burdens and as a result, plans that provide nondiscriminatory benefits will either fail to satisfy the nondiscrimination standards or will be much more likely to fail. Proposed changes to the nondiscrimination standards for cash balance plans will result in common plan designs failing to satisfy the new comparability standards, including plans that converted to cash balance by offering choice to participants. When tested on a contributions basis, most cash balance plans will not be able to satisfy the nondiscriminatory benefits requirements even if pay credits under the plan are uniform for all employees.

Post-normal Retirement Age Accruals

The proposed regulations provide specific rules for post-normal retirement age adjustments that are likely to be different than the procedures in place for the vast majority of plans that do not provide participants with a suspension of benefits notice. A plan that provides the greater of the amount available in the previous year actuarially increased to the next year or the applicable benefit for the plan year under the plan formula will almost certainly need to change how the actuarial adjustment is determined. Otherwise, the plan will fail the age discrimination standards for post-normal retirement age accruals.

Under the suspension of benefit service rules,[15] a pension plan that does not provide a suspension of benefit service notice to participants working past normal retirement age must provide the participant the better of continued accrual under the plan formula or the actuarially adjusted benefit payable at normal retirement age. The suspension of benefit service rules are a standard part of qualified plans' administrative requirements, and all qualified defined benefit plans have established suspension of benefit service procedures. Plans that do not provide the suspension of benefit service notice adjust the normal retirement age benefit according to long-standing Department of Labor (DOL) guidance.[16]

Though the proposed regulations would require significant changes to many plans' administrative procedures, it is not clear there would be any significant difference in benefits payable to late retirees. If a plan provides the actuarial adjustment for post-normal retirement age service, the actuarial adjustment to the normal retirement age benefit provides a better benefit than continued accrual under plan formula for the vast majority of participants who retire after normal retirement age. A late retiree would receive a better benefit under the proposed regulation's methodology only if (1) the participant worked multiple years after attaining normal retirement age, and (2) for at least one, but not all, years of service after normal retirement age the continued accrual under the plan formula provided a larger benefit than the actuarial adjustment. While a hypothetical situation can be created with that result, there is no clear policy reason for imposing new administrative procedures on pension plans without a clear directive that current procedures inadequately protect participants' rights. Such a demonstration has not been made.

The primary reason for the new post-normal retirement age requirements appears to be maintaining symmetry with the general rule for age discrimination. Since the general rule imposes a year-by-year accrual analysis, the post-normal retirement age rule imposes a year-by-year analysis. Given the difficulties with the general rule discussed in detail above, it does not appear that a year-by-year analysis is required or appropriate.

Proposed Solutions

As discussed above, if the proposed regulations are finalized, many defined benefit plans would fail the age discrimination rules, resulting in enormous financial difficulties for plan sponsors. The solutions necessary to correct the limitations of the proposed

[15] ERISA section 203(a)(3)(B) and Code section 411(a)(3)(B).
[16] DOL reg. 2530.203-3.

regulations go well beyond the addition of new special exceptions for different plan designs — a new general rule is needed in order to accommodate the variety of plan designs that clearly do not discriminate on account of age.

General Rule

We suggest that Treasury adopt the facial test described below. However, if Treasury is unwilling or unable to adopt the facial test, we suggest that Treasury adopt the computational test described below. Both tests will accommodate all of the plan designs that should be considered permissible. The tests give employers the ability to adopt new plan designs that address evolving employee needs and business conditions.

Facial Test

A "facial test" that examines the benefit formula written in the plan document is a more appropriate test to determine whether the rate of benefit accrual under a defined benefit plan declines or ceases based on age.. Under a facial test, a defined benefit plan would be age discriminatory if participants stop earning benefits under the plan formula, or if they start earning benefits at a lower rate under the plan formula upon reaching a specified age. A facial test is consistent with Congressional intent regarding pension age discrimination, and was the test adopted by the first federal court to apply the age discrimination standard to a qualified retirement plan.[17]

Considering whether the major components of the plan formula that define the rate of benefit accrual — specifically the benefit percentage and the definition of compensation or pensionable earnings — decrease on account of age protects the participant from inappropriate plan designs. Cash balance and pension equity plans would test whether the rate of pay credits decrease based on age.

A facial test should consider the plan formula elements that affect the participant's rate of benefit accrual, so the facial test need not consider the actuarial assumptions or factors used to determine early retirement benefits and should not consider optional forms of benefits. Not only would testing such assumptions and factors significantly complicate any demonstration that a plan does not discriminate based on age, it is difficult to rationalize such testing with the provision that early retirement subsidies (which can be built into optional form of benefit factors) are disregarded when determining the presence of age discrimination.

Under a facial test, the wide variety of plan practices and designs currently viewed as nondiscriminatory based on age will continue to be viewed in the same manner, and the necessary ability to innovate and adapt plan designs and features will not be unnecessarily restricted.

[17] *Lunn v. Montgomery Ward*, 166 F.3d 880 (7th Cir. 1999).

Computational Test

If Treasury is unwilling or unable to adopt the facial test, it should adopt a "computational test," representing a mathematical approach to determining the presence of age discrimination that, unlike the general test in the proposed regulations, takes into account economic reality. Under the computational test, a defined benefit plan would satisfy age discrimination rules if the plan satisfied either a present value test and did not fail an anti-abuse test.

The computational test is similar in concept to the "equal cost or equal benefit" approach used to determine whether other types of employee benefits discriminate on account of age. The proposed regulations effectively adopt an "equal cost or equal benefit" approach but restrict plans that can test on an equal cost basis to defined contribution and cash balance plans.

The present value test calculates an amount equal to a / (b x c) for each individual who is or could be a participant under the plan, where a, b, and c are defined as follows:

(a) the present value of the accrued normal retirement benefit the employee has earned. For this purpose, the retirement benefit is the total benefit that the employee has earned as of the date the plan is being tested for age discrimination and that is payable beginning at normal retirement age (or current age if later), expressed in the default form of benefit payable to an unmarried participant. The total benefit is the benefit payable under the plan before any offsets for benefits payable under other plans (whether or not qualified retirement plans). Present value may be calculated using any reasonable interest rate, mortality table and methodology. Also, consistent with the suspension of benefits rules, the present value factor for an employee who is over normal retirement age would equal the present value factor at normal retirement age. For this purpose, (a) may be calculated using a methodology that is similar to the methodology used to determine equivalent allocation rates under section 1.401(a)(4)-8(c)(2) of the regulations.

(b) the employee's service as defined by the plan for purposes of calculating the retirement benefit described in (a)

(c) the employee's compensation as defined by the plan for purposes of calculating the retirement benefit described in (a)

The present value test is consistent with the test in the proposed regulations for plans other than eligible cash balance plans, except the present value test considers (1) the economic value of an employee's benefits, (2) the employee's entire retirement benefit accrued to date, and (3) the employee's entire retirement benefit under the plan's benefit formula prior to offset by another benefit.

Hybrid plan formulas accrue benefits using a present value concept, so it is reasonable to allow such plans to test under the computational test simply by looking at the rate of accrual under the terms of the plan formula. So the computational test should indicate that if a plan formula benefit is expressed in terms of a present value or immediate payment, the computational test is satisfied if the pay credits or points do not decline on account of age.

The anti-abuse test will prevent potential abuses under the computational test. Under the anti-abuse test, a defined benefit plan would not satisfy the age discrimination rules if an employee stops earning benefits under the plan formula, or starts earning benefits at a lower rate under the plan formula, once the employee attains a particular age. For example, a traditional plan that provides that an employee earns a normal retirement benefit equal to 2.0 percent of pay for service at age 45 and normal retirement benefit equal to 1.98 percent of pay for service at age 46 would satisfy the present value test, but fail the anti-abuse test.

The computational test is consistent with the age discrimination requirements under the proposed regulations for defined contribution plans and cash balance plans. In both cases, the proposed regulations look at the comparative contributions for younger and older participants. If the current year individual contribution rate for older employees equals or exceeds the rate for younger employees, the plan passes. For example, if younger employees earn a contribution of 2 percent of compensation, older employees, quite simply, must also earn a contribution of at least 2 percent of compensation.

This computational test is based on the present value of benefit provided to employees, a standard consistent with other provisions of age discrimination laws and reflecting the basic tenet that the time value of money is not "on account of age." Considering the present value of benefits allows a wide variety of defined benefit plans that have never been considered age discriminatory to continue to comply, such as pension equity plans, contributory plans, variable annuity plans, and indexed career average plans. A present or economic value test would also allow cash balance plans to be viewed as non-age discriminatory without the need for a special exception.

Testing the gross benefit allows for many plan designs that provide a coordinated set of benefits and have never been considered age discriminatory in the past. A plan that coordinates pension benefits with Social Security benefits should not be viewed as age discriminatory simply because Social Security benefits are increased at later ages. An employer that generously provides past service benefits to an acquired group of employees, but coordinates that benefit with benefits from the prior employer's plan, should not be penalized and viewed as discriminating based on age.

Determining accrual rates or present value considering the participant's entire period of service reflects how benefits are accrued under a pension plan and eliminates potential difficulties caused by variances in plan formula, interest rates, or other economic factors affecting benefits or benefit values that are outside the sponsor's control. Valuing benefits under an accrued-to-date method also allows for standard plan amendments to traditional plans.

Conversions

The proposed regulations contain rules limiting the types of transition benefits that can be provided to participants in a hybrid plan conversion. The proposed regulations also restrict how the opening account balance in an eligible cash balance plan can be determined, allowing the opening account balance to be based on the present value of an employee's accrued benefit, or requiring an opening account balance of zero with benefits under the prior plan formula maintained in that form.

The suggested general rules, both facial and computational, cover a wider variety of conversion and transition techniques, including the application of the cash balance formula to all service. Accordingly, the proposed regulations should eliminate the special requirements for plan conversions, with one exception allowing recognition of existing or foregone early retirement subsidies. For example, the exception should allow the opening account balance to reflect some or all of the participant's accrued early retirement subsidy. Not only does this type of transition benefit protect participants during a plan conversion, it provides a level playing field for defined benefit and defined contribution plans. Other types of transition benefits the exception should permit are transition credits or compensation adjustments designed as a proxy for early retirement subsidies, as well as a facts and circumstances test allowing the IRS to rule on whether other types of transition benefits are considered age discriminatory.

Finally, the proposed regulations impose new requirements for determining the initial cash balance account for participants who have attained normal retirement age at the time of conversion. The basis for these new requirements is not clear and appears to be based in the restrictive general rule under the proposed regulations. With the changes to the general rule suggested herein, there does not appear to be any reason for requiring different conversion methods for older employees than for younger employees. The special requirements for determining initial cash balance accounts for post-normal retirement age participants should be eliminated.

Even with these changes regarding plan conversions, the proposed regulations need to clearly state the prospective nature for any standards imposed on hybrid plan conversions. Plan sponsors who converted to a cash balance plan based on a reasonable, good faith interpretation of the law and guidance available at the time cannot be penalized or subject to challenge because prior conversions do not precisely conform to standards imposed after the fact. Final guidance should clarify that, regardless of any restrictions imposed on future conversions, prior conversions are subject to a reasonable good faith standard that is satisfied by a broad range of transition methods.

Use of a reasonable, good faith standard for hybrid plan conversions predating the effective date of final regulations should apply not only for purposes of determining age discrimination under the Code, but ERISA and ADEA as well. If the Treasury

Department does not feel it has the authority to establish such a standard,[18] guidance from the DOL and EEOC to that effect may be necessary.

General Nondiscrimination in Benefits Rules

Imposing the new comparability rules on cash balance plans is a very significant change in the administrative and compliance scheme for cash balance plans, a change too significant to adopt without a strong policy basis. If the recommended changes to the age discrimination standards are adopted, there is not a sufficient reason to adopt the new comparability standards for cash balance plans.

The primary rationale for the cash balance new comparability rules is that if cash balance plans are treated as defined contribution plans for purposes of age discrimination testing, they should be treated as defined contribution plans for general nondiscrimination testing. But the suggested revision to the general rule eliminates the special cash balance exception, leaving only a general rule that can be applied to a wide variety of defined benefit plans. The presence of a general age discrimination test that considers the present value of benefits under a defined benefit plan is not a sufficient basis for imposing the new comparability standards on every or any kind of defined benefit plan. Under the suggested change to general rule, the ability to test for age discrimination on the basis of present value is not limited to one kind of plan design. Many traditional plans will need to test for age discrimination on the basis of present value.

Additionally, the original policy rationale for imposing the new comparability on defined contribution plans does not appear to apply to cash balance plans. The defined contribution new comparability standards were adopted in large part because of perceived abuses in defined contribution plan designs where different allocation rates were provided to different classifications of employees, with nonhighly compensated employees receiving significantly lower allocation rates than highly compensated employees. There is no evidence that employers are adopting cash balance plan designs similar to the defined contribution plan designs that the new comparability rules were intended to eliminate. Without confirmation that cash balance plans are providing different rates of pay credits in a manner that offends public policy, rules as onerous as the proposed new comparability standards for cash balance plans should be withdrawn.

Post-normal Retirement Age Accruals

While the methodology for determining the actuarial adjustment for post-normal retirement age service is technically sound, so is the methodology currently used by every qualified pension plan in the country that does not issue participants a suspension of benefits notice. There does not appear to be any reason to make every plan that actuarially adjusts benefits for late retirement change its methodology for making that adjustment.

[18] Such authority appears to be delegated to the Treasury Department under the Reorganization Act of 1978 and 29 USC 623(i)(7).

Maintaining symmetry with the annual accrual test under the proposed general rule is not sufficient reason to cause such a widespread change in plan administrative procedures, especially when such change is likely to result in virtually no change in actual benefits delivered to the vast majority of participants working past normal retirement age. The requirement to change to a methodology that doesn't significantly alter the level of benefits provided needs to be balanced against the cost and upheaval in administrative systems that such a change would cause.

The suggested change to the general rule expands the methods for determining accrual rates or present value to include methods considering the participant's entire period of service with the employer, a method consistent with the current method for actuarially adjusting benefits. The proposed regulations should approve the current method for actuarially adjusting participants' benefits for post-normal retirement age service.

Summary

The proposed age discrimination regulations represent a significant step toward ensuring the continued vitality of the private employer-sponsored defined benefit system, but further steps are required to attain that goal. The suggested changes to the proposed regulations described herein protect participants against age discrimination, and provide the necessary flexibility for continued evolution of the system. Finalizing the proposed regulations as drafted would result in many plans that have never been questioned in the past being considered age discriminatory, while adopting the suggested revisions will ensure that such plans continue to be viewed as compliant.

The importance of a strong defined benefit system has never been greater. Employees have seen their 401(k) accounts decrease sharply after three straight years of equity-market losses. Corporate scandals have shredded some employees' retirement hopes altogether. This is not the time to make sponsoring defined benefit plans even more burdensome to sponsors, but instead an opportunity to reverse the decades-long decline in the defined benefit system.

We appreciate the opportunity to express our views and strongly urge the IRS and Treasury to revise the proposed regulations as necessary in order to preserve the defined benefit system.