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The Cash Balance Controversy

Edward A. Zelinsky
Benjamin N. Cardozo School of Law, zelinsky@yu.edu

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TABLE OF CONTENTS

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[*] Edward A. Zelinsky is a Professor of Law at the Benjamin N. Cardozo School of Law of Yeshiva University. The normal caveat to an author's acknowledgment – that he alone is responsible for all errors and views – bears particular emphasis here. Cash balance pension plans are a controversial and fast-evolving topic. I do not believe that anyone who has assisted my research or thought processes agrees with all (perhaps much) of what I have written. Nevertheless, a great many people who disagree with my conclusions have been generous with their time and advice. I am grateful for their help and the spirit in which it has been offered. Among those I would thank are the participants in the Ernst & Young tax policy seminar at Georgetown University Law Center, presided over by Professor Clarissa C. Potter; Professors Peter M. van Zante, Jonathan Barry Forman, Bruce A. Wolk, John H. Langbein, and James Wooten; Attorneys Alvin D. Lurie and William K. Bortz; Robert J. Michalski, Patrick J.Purcell, Stanley Fendley, and Doris Zelinsky.

I. INTRODUCTION

A generation ago, few Americans outside the qualified plan community were familiar with either the newly-created individual retirement account (IRA) or the soon-to-emerge 401(k) plan.

Today, of course, the IRA in its myriad forms[1] and the 401(k) arrangement are well-known features of American life, for many Americans the most valuable items of their financial portfolios. Similarly, the cash balance pension plan was, until recently, poorly understood even within the world of qualified plan cognoscenti. However, with remarkable rapidity, the cash balance format has emerged as a significant configuration for deferred compensation arrangements and as a major source of political controversy.[2]

The critics of cash balance plans argue that the conversion of conventional defined benefit pensions to the cash balance format is both unfair to older workers[3] and misunderstood by those affected.[4] The defenders of the cash balance motif rejoin that cash balance plans are better comprehended by plan participants than traditional defined benefit formulas[5] and that the cash balance

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[1] The traditional IRA under section 408 is now supplemented by the Roth IRA of section 408A, the educational IRA of section 530, and the SEP IRA of section 408(k). All references to ERISA refer to the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829.

[2] *See, e.g.*, Greg Hitt, *Fight Over Corporate Pensions Enlivens Vermont Race*, WALL ST. J., Oct. 8, 1999, at A20; Richard A. Oppel, Jr., *Cash-Balance Pension Plans Under Scrutiny By Tax Agency*, N. Y. TIMES, Sept. 17, 1999, at C1; Richard A. Oppel, Jr., *I.B.M. Does An About-Face On Pensions*, N. Y. TIMES, Sept. 18, 1999, at C1; Ellen E. Schultz, *Utility's Pension Plan Allowing Choice Offers Contrast to the Bitterness at IBM*, WALL ST. J., Sept. 23, 1999, at C1; Stephanie Armour, *Pension Outcry Not Just at IBM, Others Joining the Benefits Debate*, USA TODAY, Sept. 23, 1999, at B1; Hope Viner Samborn, *Now You See It, Now You Don't*, 85 A.B.A. J. 34, Nov. 1999; Patrick J. Purcell, *Pension Issues: Cash-Balance Plans*, CONGRESSIONAL RESEARCH SERVICE, Sept. 2, 1999.

[3] *See, e.g.*, Lee A. Sheppard, *The Down-Aging of Pension Plans*, TAX NOTES TODAY (Jan. 11, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 6-6); *Stop Issuing Determination Letters For Cash Balance Conversions, Representatives Urge*, TAX NOTES TODAY (Sept. 3, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 171-36, ¶ 11) [hereinafter *Stop Issuing Determination Letters*]("Given the serious and unresolved age discrimination questions that exist, the Service should not bless these arrangements."); Colleen T. Congel, *EEOC Head Repeats Promise to Review Cash Balance Age-Bias Complaints*, 178 DAILY TAX REP. (BNA), Sept. 15, 1999, at G-4.

[4] *See* Ryan J. Donmoyer, *Taxwriters Introduce Cash Balance Plan Legislation Requiring Disclosure*, TAX NOTES TODAY (Oct. 8, 1999)(LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 195-3). *See also* Colleen T. Congel, *Outlook for Pension Reform Uncertain; Expansion of Notice Rules Still Possible*, DAILY TAX REP. (BNA), Sept. 14, 1999, at G-3 ("[M]any pension experts said that, if plan conversions [to cash balance formulas] continue to generate widespread controversy, chances are favorable that some form of disclosure legislation will be enacted."). The evident premise of such legislation is that, under current law, participants have an inadequate grasp of these conversions.

[5] *See, e.g.*, Arleen Jacobius, *Motorola Adds PEP to its Defined Benefit Plan*, 27 PENSIONS & INVESTMENTS No. 14, July 12, 1999, at 1 (quoting Sheila Forsberg, director of global retirement benefits strategy of Motorola, Inc., as saying that Motorola's new pension equity

design allows employers who might otherwise terminate their defined benefit arrangements to stay within the defined benefit system.[6]

In an effort to evaluate these competing claims, Part II describes the cash balance format and contrasts that format with the traditional defined benefit pension. Part III introduces the legal framework currently governing cash balance plans. Part IV discusses both the critique and the defense of cash balance arrangements. Part V concludes by finding that, as a matter of law, the typical cash balance plan violates the statutory prohibition on age-based reductions in the rate at which participants accrue their benefits. However, as a matter of policy, there is no sound reason to bar cash balance plans nor is there a logical basis for the resentment engendered by the conversion of traditional annuity-providing pension plans to the cash balance format, given a baseline which accepts both defined contribution plans and cash balance plans created from scratch. Moreover, the proponents of cash balance plans are correct to contend that such plans permit employers to remain within the defined benefit system rather than debark to the defined contribution universe. As a matter of psychology, the resentment against cash balance conversions, deeply and sincerely held, largely stems from psychological expectations in the continuation of the status quo, rather than any legal or logical entitlement to the continuation of existing pension coverage.

In the best of all worlds, the proper resolution of the cash balance controversy would be to amend the statutory prohibitions on age-based reductions in benefit accrual rates to legitimate cash balance plans and to permit private ordering between employers and employees (or their unions) to govern such conversions. Since

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plan, a type of cash balance arrangement, "is much simpler to understand" than conventional defined benefit pensions).

[6] *See, e.g.*, *ERIC Defends Cash Balance*, 27 PENSIONS & INVESTMENTS No. 15, July 26, 1999, at 1 (describing the position of the ERISA Industry Committee: "the development of cash balance plans and other innovative hybrid plans have revived the faltering defined benefit pension system"); Colleen T. Congel, *Cash Balance Pension Plans Draw Both Praise, Criticism*, DAILY TAX REP. (BNA), March 3, 1999, at J1 ("Practitioners and sponsors of cash balance plans dismiss the negative puffery, insisting that cash balance plans allow employers to stay in the defined benefit plan system by embodying the principle of equal pay for equal work.").

we do not live in the best of all worlds, as a matter of politics, I propose a package of legislative compromises which, given the political realities of the situation, is the best we can do.

I realize that this analysis brings no ultimate comfort to the proponents of cash balance plans (since I conclude that most such plans violate current statutory provisions on age-based reductions in benefit accrual rates), to the opponents of such plans (since I conclude that efforts to stop such conversions legislatively are not a wise idea), or to academic purists (since I conclude that the right approach to the cash balance controversy – private ordering – is neither politically nor psychologically feasible). I can only take comfort in my grandmother's admonition: if you are thinking what others are, you haven't thought for yourself.

II. CASH BALANCE PENSION PLANS: AN OVERVIEW

A. *Final Average Defined Benefit Plans*

The common characterization of the cash balance plan is that it is a defined benefit pension designed to look like a defined contribution arrangement.[7] The conventional defined benefit plan promises a retiree an annuity based on the retiree's earnings history and her completed years of service. The most common defined benefit formula is the "final average" format under which the retiree's annuity is a percentage of her highest paid years[8] multiplied by a factor reflecting the retiree's length of service.

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[7] *See, e.g.*, Treas. Reg. § 1.401(a)(4)-8(c)(3)(i):

> A cash balance plan is a defined benefit plan that defines benefits for each employee by reference to the employee's hypothetical account. An employee's hypothetical account is determined by reference to hypothetical allocations and interest adjustments that are analogous to actual allocations of contributions and earnings to an employee's account under a defined contribution plan....

Id. *See also* Jonathan Barry Forman, *Professor Responds to Cash-Balance Pension Plan Article*, TAX NOTES TODAY (Feb. 1, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 20-141, ¶ 2) ("A cash balance plan is a defined benefit plan that looks like a defined contribution plan.").

[8] Typically, these high earning years occur at the end of the employee's career; hence, the moniker "final average." Just as plausibly, such defined benefit plans could be denoted "high paid average" plans since the retiree's retirement annuity is based on her years of highest earnings.

For example, a final average defined benefit formula might be fifty percent of the participant's average compensation for her three highest paid years multiplied by a years of service fraction, the numerator of which is the retiree's actual years of service and the denominator of which is thirty, representing the number of years in a career spent entirely with the employer sponsoring the plan. If an employee made $58,000, $60,000, and $62,000 in each of her last three years of employment, if these were her highest paid years, and if the employee had worked for the sponsoring employer for twenty years, the employee would be entitled to a retirement annuity of $20,000 per year.[9]

Final average defined benefit plans are said to be "backloaded"[10] in the sense that the employee's last years of participation are particularly valuable for her and particularly costly for her employer.[11] Three factors underpin this backloading phenomenon. First, higher (typically later) salaried years rachet the older employee's salary average and, hence, her promised pension benefit which is a function of that average. Second, the pension impact of salary increases is ordinarily magnified for older participants by higher year of service fractions, reflecting their seniority. Third, older workers' proximity to retirement requires larger contributions from employers to provide for such workers annuities attributable to later years' employment since such late-career annuities will be commencing relatively soon.

Suppose, to continue our example, the retiree had a starting salary of $20,000 annually, which increased over time. In this situation, the last years of employment, by elevating the relevant salary average, correspondingly elevate the employee's pension entitlement. If, for example, the employee's annual salary had remained at $20,000 for her entire career, the employee's pension, because of her lower average salary, would have been $6667 per year.[12]

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[9] Calculated as follows: 0.5[($58,000 + $60,000 + $62,000)/3] x 20/30 = $20,000.

[10] As will become clear, the meaning of the term "backload" varies with the context within which it is used.

[11] Section 411(b) and ERISA section 204 preclude more explicit forms of backloading. These provisions are discussed *infra* Part III(B).

[12] Calculated as follows: 0.5[($20,000 + $20,000 + $20,000)/3] x 20/30 = $6667.

In the infrequent,[13] but heuristically useful, case where the employee earns a stable salary for most of her career with her compensation spiking at the very end, the employee's pension on retirement is the same as if her salary had crept up gradually over the course of her career, since the final average formula looks only to the average created by the highest years, not to the path by which the employee got there. If our hypothetical employee had earned $20,000 for the first seventeen years of her career and then earned $58,000, $60,000, and $62,000 during the three final years, her pension would be same as the pension to which she would have been entitled had her income increased incrementally over the first seventeen years. In either the scenario of incremental salary increases over time or the alternative in which the employee's compensation is flat until the very end of her career, the employee's final three years, because they are her three highest paid years, elevate the relevant salary average for pension purposes and, hence, elevate the employee's pension.

Moreover, the pension impact of late-career salary increases is typically magnified by the older employee's larger years of service fraction. Consider, for example, the pension economics of a $1000 increase in salary average for a thirty-five year-old employee with one year of service and the same $1000 increase in salary average for a sixty-five year-old employee with twenty years of service. Again, suppose a final average formula which promises a pension benefit of fifty percent of final average compensation times a fraction, the numerator of which is the employee's actual years of service and the denominator of which is thirty.

The $1000 salary increase elevates the younger employee's pension annuity at retirement by $17 per year;[14] the same $1000 increase boosts the older worker's retirement annuity by $333 per year.[15] The differential is attributable to the younger participant's small years of service fraction (1/20) and the more senior

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[13] But not totally implausible. A common technique under government plans is to appoint someone with long service but low salary to a higher paid position at the end of her career to ratchet her pension entitlement. Thus, for example, a veteran, part-time legislator will be appointed at the end of her career to a full-time commissionership so that the higher commissioner's salary will elevate her final average salary and thus her pension.

[14] Calculated as follows: $1000 x 0.5 x 1/30 = $17.

[15] Calculated as follows: $1000 x 0.5 x 20/30 = $333.

employee's larger fraction (20/30), reflecting her twenty years of employment.

Finally, an employee's last, high-paid years significantly increase the employer's pension costs because of the employee's proximity to retirement. Because the employee earns her higher salary (and, hence, her higher pension benefit) late in her career when she is close to retirement, there is little time for the employer's plan contributions to earn investment income. Accordingly, the employer must itself fund relatively more of the higher pension entitlement since there will be comparatively little investment growth to offset these higher costs.

Assume, for example, that an employer has recently hired both a thirty-five year-old employee and a sixty-two year-old employee. Let us assume, further, that both employees earn $20,000 annually during the first year of plan participation and that the employer's final average plan guarantees an annuity equal to fifty percent of final average salary times the now familiar years of service fraction, i.e., actual years of service divided by thirty. On these facts, both employees earn an annuity at retirement of $333 for this first year of employment.[16] As to the older worker, it costs[17] the employer $2431[18] to currently fund this annuity beginning in three years; in contrast, for the younger employee, it costs the employer $304[19] to currently fund this retirement annuity commencing in thirty years. The employer must contribute relatively little for the younger employee since her contribution will accrue investment earnings for the next three decades before the benefit is due at age sixty-five. Conversely, providing the same retirement annuity for the older employee is more expensive since that annuity will commence sooner, i.e., in three years. There is, accordingly, less time for the employer's contribution to grow

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[16] Calculated as follows: 0.5 x $20,000 x 1/30 = $333.

[17] In this and in the calculations that follow, I have employed a number of actuarial assumptions. For example, an interest rate of eight percent is assumed. Also, assumed is that one dollar of annuity income starting at age 65, purchased via a lump sum payment, costs $9.196. This annuity purchase rate comes from a well-known table, 83-GAM Table at six percent. Different actuarial assumptions would, of course, lead to different numbers than those in the text; however, different numbers would not alter the substance of my conclusions or argument.

[18] Calculated as follows: $333 x 9.196/1.08^3 = $2431.

[19] Calculated as follows: $333 x 9.196/1.08^30 = $304.

through investment experience to provide the funds necessary for that annuity. The employer must thus expend more of its own funds to provide that annuity sooner.

Another way of characterizing these facts is that an annuity starting at age sixty-five has a greater present value for an older employee, closer to that age, than for a younger worker, farther from that age. The conclusion, however, remains the same: traditional pension benefits, in the form of an annuity, are more costly to provide to older workers and consequently more valuable to them.

In short, for pension purposes, the last years[20] of an employee's career are particularly significant if covered by a traditional final average formula defined benefit pension plan; a central factor arousing concern about the conversion to cash balance arrangements is the resulting deprivation to employees of the pension impact of these late-career years.[21]

B. Defined Contribution Plans

Unlike defined benefit plans,[22] which specify the amount the employee will receive from her retirement plan, defined

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[20] As observed above, these last years are a proxy for the employee's high paid years. *See supra* note 8.

[21] *See infra* Part II(D)(1). The employer sponsoring a final average defined benefit plan can mitigate the need for costly late-career funding by prefunding projected retirement benefits on a level basis. In the initial year of employment when a plan participant earns $20,000, her employer can contribute to the plan, not on the basis of the employee's current annual salary of $20,000, but by projecting the greater compensation and thus the greater pension to which the employee will ultimately be entitled twenty years hence. This smoothing of the employer's pension funding obligation can be analogized to the level premium payments under permanent life insurance policies. It entails higher payments up-front with a compensating (i.e., reduced) funding commitment at the end of the employee's career, her higher pension having been prefunded earlier. *See* MCGILL ET AL., FUNDAMENTALS OF PRIVATE PENSIONS 611-12 (7th ed. 1996).

[22] The economics of final average plans, for both the employee and employer, are different from the economics of either career average formulas or so-called "flat" benefit formulas. Career average formulas produce smaller pensions based on lower average salaries tied to each employee's entire compensation history rather than just the elevated average of the employee's final high paid years; flat benefit formulas provide benefits based solely on length of service regardless of salary. However, these two alternatives are less frequently utilized today than final average formulas; indeed, the cash balance controversy is largely about the abandonment of final average formulas for the pseudo-defined contribution approach of cash balance arrangements. *See id.* at 202-11.

contribution arrangements specify the employer's funding commitment without guaranteeing or limiting the total to which those funds will grow by the time of retirement. In simplest terms, a defined benefit pension, as its name implies, grants the employee an output specified in terms of retirement income while a defined contribution arrangement, as its equally apt moniker indicates, grants the employee an input specified in terms of employer contributions.

Let us now suppose that, in lieu of a defined benefit plan, an employer embraces a typical defined contribution formula: ten percent of current compensation. Under this defined contribution format, the employer contributes, for an employee earning $20,000 annually,$2000, [23] which is placed in an individual account for the employee.[24] The employee is not guaranteed the ultimate amount to which this $2000 contribution will grow by retirement via investment earnings nor is there any limit to which this contribution may burgeon via such earnings. Rather, each year (or more frequently), the employee's account, holding cumulative employer contributions, is credited with investment returns and charged with investment losses. At any point in her career, the employee's account has a balance reflecting both the aggregate contributions made to the account and the account's investment experience to date. At retirement, the account's balance, whatever it may then be, will constitute the employee's retirement benefit.

Under a defined benefit plan, the employer, having specified a retirement income the employee will receive, incurs the risk of bad investment experience (since the employer must make up any shortfall to provide the employee with the promised benefit) and recoups the rewards of good investment experience (since a more amply-funded plan requires less additional employer contributions to finance promised benefits). In contrast, in the defined contribution context, the employee absorbs the risk of poor investment performance (since such performance decreases the employee's account balance and, hence, her retirement income) and garners superior investment return (since such return

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[23] Calculated as follows: $20,000 x 0.10 = $2000.

[24] For this reason, defined contribution plans are also known as "individual account" plans. *See* ERISA § 3(34).

augments the balance of the employee's account).

C. Cash Balance Plans

Cash balance plans mimic defined contribution arrangements since the employee's pension entitlement under a cash balance formula is specified in terms of a theoretical account balance. However, cash balance plans are defined benefit schemes since the plan (and, ultimately, the employer) guarantee the employee this theoretical balance – no more, no less.

Let us now assume an employee earning $20,000 annually who is covered by a cash balance plan; the plan guarantees her the hypothetical account balance resulting from theoretical annual contributions of ten percent of salary[25] nominally invested at five percent interest.[26] Let us further suppose that, for the year, the plan actually earns an eight percent return on the money it holds. At the end of the year, the employee's notional account balance would be $2100, reflecting the hypothetical contribution of ten percent of the employee's salary (i.e., the pay credit), plus theoretical annual earnings on that amount at five percent (i.e., the interest credit).[27] However, the plan is "overfunded" in the sense that the plan has on hand $2160, reflecting the plan's actual investment return of eight percent.[28] In a true defined contribution context, that larger amount would be the employee's, subject to the satisfaction of vesting requirements.[29] However, in a cash balance setting, the employee is only entitled to the smaller, theoretical amount (the pay credit plus the interest credit) since this is the benefit defined for her by the plan. By the same token, if the plan's investment experience is less than five percent, the employee is still entitled to the benefit specified for her in terms of a theoretical account balance, i.e., $2100. That the actual

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[25] This portion of the cash balance formula is typically denoted as the "pay credit." *See, e.g.*, Stuart L. Brown, *Chief Counsel's Testimony At Senate Hearing On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-11, ¶ 6).

[26] This portion of the cash balance formula is typically denoted as the "interest credit." *See id.*

[27] Calculated as follows: $2000 x 1.05 = $2100.

[28] Calculated as follows: $2000 x 1.08 = $2160.

[29] These are established in section 411(a) and ERISA section 203.

resources of the plan are less than this figure is the employer's problem to remedy, either through additional contributions or better investment performance in the future.

An important variant of the cash balance format, the pension equity plan (PEP), defines the employee's notional account balance, not with pay and interest credits, but as the product of cumulative annual percentages multiplied by the employee's final average salary. Consider, for example, a pension equity plan which credits to the participant ten percent annually; at the end of five years, the employee's hypothetical account balance would be fifty percent[30] of her average salary for her high three years. At the end of twenty years, the employee's PEP account balance would be two hundred percent[31] of her final average salary. To return to the situation in which the employee's salaries in years 18, 19, and 20 are $58,000, $60,000, and $62,000, her theoretical PEP account balance (and hence the benefit promised her) would be $120,000.[32] If, by dint of contributions and superior investment performance, the plan has on hand more than this, the employee nevertheless receives her (lower) specified benefit. By the same token, if the PEP's resources on hand are less than the $120,000 promised the employee, the employer must make up the difference to provide the promised theoretical account balance.

Sometimes the PEP increases the percentage credited to the employee annually as the employee acquires greater seniority. For example, the employer's plan could credit the employee's theoretical account balance with ten percent for each of the employee's first ten years of service and twenty percent for the years of employment thereafter. In this case, the employee, at the end of her twenty year career, would have amassed a factor of three hundred percent;[33] at retirement, her notional account balance would be that factor multiplied by her final average salary for a total of one hundred and eighty thousand dollars.[34] Thus, PEPs retain some of the backloaded flavor of conventional final average formulas, particularly when the annual percentage

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[30] Calculated as follows: 10% x 5 years of service.
[31] Calculated as follows: 10% x 20 years of service.
[32] Calculated as follows: 200% x (58,000 + 60,000 + 62,000)/3 = $120,000.
[33] Calculated as follows: (10% x 10) + (20% x 10) = 300%.
[34] Calculated as follows: 300% x (58,000 + 60,000 + 62,000)/3 = $180,000.

increases for the employee's later years.

D. The Effects of Cash Balance Conversions

The creation of cash balance plans *ab initio* is relatively noncontroversial.[35] The current debate has been stimulated by the rash of conversions pursuant to which existing defined benefit arrangements are transformed from a conventional defined benefit format (i.e., a promised annuity based on the employee's length of service and final average salary) to the cash balance motif.[36]

1. Cash Balance Conversions and Normal Retirement

To see the source of controversy, consider initially an older employee with substantial service covered by a traditional final average formula, which guarantees the employee at retirement an annuity equal to fifty percent of her final average salary times a years of service fraction, the numerator of which is the employee's completed years of service and the denominator of which is thirty. This older employee, having completed seventeen years of employment and being three years from retirement, stands on the verge of her late-career, high salary years which will increase her pension benefits significantly. However, before those years occur, let us assume that the employer converts its defined benefit plan to the cash balance format for future years. Thus, on retirement, the employee will receive a traditional annuity based on her pre-conversion salary history and seventeen years of actual service. In addition, at retirement, she will receive a theoretical cash balance for her final three years of employment under the new cash balance formula applicable to those last years.

To complete this scenario, let us assume that, just before the

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[35] As I discuss, *infra* Part V(D), the controversy surrounding the conversion of existing traditional defined benefit plans to the cash balance format must largely be explained in political and psychological terms since new cash balance plans raise the same issues, but have generated little controversy.

[36] *See, e.g.*, *Stop Issuing Determination Letters*, *supra* note 3, ¶ 1 ("We are writing about the apparent abuses and possible violations of the law which occur when an employer *converts* its defined benefit pension from a traditional formula to a cash balance formula.") (emphasis added).

conversion of the defined benefit plan to the cash balance format, the employee's high three year salary average is $50,000, the employee's salary for each of her three last working years is $60,000 (producing a new high average of $60,000), and that the new cash balance formula grants to the employee's theoretical account a pay credit equal to ten percent of her compensation for the year and an interest credit of five percent annually.

On these assumptions, the employee, for her seventeen years of coverage under the traditional defined benefit format, is entitled to an annuity of $14,167.[37] Had she been permitted to earn the final years' pension benefit under that format, she would have received an annuity of $20,000 annually at retirement,[38] reflecting the impact of her last three years of employment under a final average formula. However, instead of this larger annuity, the employee will receive a cash balance benefit of $19,861 consisting of theoretical pay-based contributions and interest for her last three years of employment.[39]

In lump sum terms, the annuity to which the employee is actually entitled for seventeen years of conventional coverage is worth $130,280 at retirement.[40] Had there been no conversion to the cash balance formula for her last three years, the larger

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[37] Calculated as follows: 0.5 x $50,000 x 17/30 = $14,167.

[38] Calculated as follows: 0.5 x $60,000 x 20/30 = $20,000.

[39] For the purposes of this calculation, it is assumed that the employee is, at the beginning of each year, credited with a theoretical contribution based on her salary for that year and is credited, at the end of the year, with interest for the entire year. Thus, at the beginning of the first year of the cash balance plan, the employee's cash balance account initially consists of the pay credit of $6000 (i.e., 10% x $60,000). At the end of the first year, the employee's account is then credited with hypothetical earnings of 5% (i.e., $6000 x 0.05 = $300).

On the first day of the second year, the employee's cash balance account ($6300, representing the pay and interest credits from the first year) is then credited with an additional employer contribution of $6000, bringing the total to $12,300. This amount accumulates notional interest at 5% for the year calculated as follows: 0.05 x $12,300 = $615. Thus, at the end of the second year, the employees cash balance account comes to $12,915 (i.e., $12,300 + $615).

At the beginning of the third year, this amount is supplemented by the final year's pay credit of $6000 (i.e., $12,915 + $6,000 = $18,915). This amount accumulates theoretical interest at 5% over this last year (i.e., 0.05 x $18,915 = $946). Thus, the employee's cash balance account finally comes to $19,861 (i.e., $18,915 + $946). The employee is guaranteed this amount under the plan, no more, no less – regardless of the plan's actual earnings during this three year period.

[40] Calculated as follows: 9.196 x $14,167 = $130,280.

annuity she would have earned would have been worth $183,920[41] at retirement. The difference in the present value of these two annuities ($53,640)[42] exceeds the benefit from the cash balance plan by $33,779.[43] Thus, in this example, the conversion to the cash balance format reduces the older employee's pension wealth by $33,779 in contrast to the level such wealth would have grown under the traditional defined benefit format.

The employer could cushion or eliminate the loss occasioned by the cash balance conversion via any number of transition arrangements. Most directly, the employer could permit the older employee and her similarly-situated co-workers to remain with the traditional defined benefit arrangement until retirement, assigning to the new cash balance formula only new and younger workers. To the extent the conversion to the cash balance format is intended to reduce the employer's costs,[44] this approach would nullify the employer's anticipated savings since older employees (for whom the cost of traditional pension coverage is more expensive than the cost of the defined contribution format) would opt to remain with the final average arrangement, more valuable for them and correspondingly pricier for the employer. On the other hand, to the extent that the employer pursues the cash balance motif to attract younger and more mobile workers,[45] an elective transition rule permits older employees to stay with their existing coverage while younger employees are funneled into the new cash balance plan.

Alternatively, to lessen the impact of conversion, the employer, in lieu of a plain vanilla cash balance formula (e.g., 10% of salary per year), could use a PEP weighted towards older workers. For example, suppose the employer adopted a pension equity formula under which the employee's theoretical cash balance account is determined by multiplying the employee's final average salary by cumulative annual percentages and that, for employees with fifteen or more years of employment, the annual percentage credited is twenty-five percent per year. In that case, the

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[41] Calculated as follows: 9.196 x $20,000 = $183,920.
[42] Calculated as follows: $183,920 - $130,280 = $53,640.
[43] Calculated as follows: $53,640 - $19,861 = $33,779.
[44] *See infra* pp.24-26.
[45] *See infra* pp. 26-27.

employee's theoretical account balance, owed to her by the plan at retirement, is $45,000[46] – a benefit which largely (though not completely) compensates for the pension wealth lost ($53,640) as a result of the abandonment of the traditional defined benefit formula.

Another method of buffering this employee from the conversion to the cash balance motif would be to grant the employee's new notional account with extra credits to compensate for the pension wealth which the employee would have earned had the traditional plan remained intact.

However, in the absence of these or other ameliorative measures, in this example, the conversion of the employer's final average formula defined benefit plan to the cash balance configuration deprives the older employee of the pension impact of her late career years and thereby effects a significant reduction of the older employee's pension wealth in comparison to the pension she would have earned had she completed her career under the conventional defined benefit plan.

While the conversion to the cash balance format generally harms older employees, younger employees usually gain from the conversion. To see this, let us postulate a thirty-five year-old worker who earns $20,000 in her first year of employment. Under the traditional final average formula we have been assuming,[47] this young employee earns for this year an annuity at retirement of $333,[48] an annuity with a current present value of $304.[49] In contrast, under the cash balance alternative,[50] this younger worker, for her first year of employment, receives a theoretical allocation of $2100 to her hypothetical account balance.[51]

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[46] Calculated as follows: 0.25 x 3 x $60,000 = $45,000.

[47] An annual annuity benefit at retirement equal to fifty percent of the participant's final average salary times the years of service fraction (years of actual service divided by 30). To reiterate, this is merely an example of a typical final average formula. The details of the formula do not affect the analysis.

[48] Calculated as follows: 0.5 x $20,000 x 1/30 = $333.

[49] Calculated as follows: $333 x 9.196/1.08^30 = $304.

[50] Note that a pay credit of ten percent of salary and an interest credit of five percent is assumed. Again, this formula is for heuristic purposes; the details of the formula do not affect the analysis.

[51] The young employee's cash balance account is pay credited with ten percent of her salary (0.10 x $20,000 = $2000) and is interest credited with five percent earnings on this amount ($2000 x 0.05 = $100) for a total of $2100.

Tinkering with the traditional pension and cash balance formulas can alter the precise outcomes in these examples. However, at its most basic tenet, a traditional plan's promise to pay an annuity in thirty years has minimal present value for a younger worker today in contrast to a theoretical allocation under the pseudo-defined contribution formula of a cash balance arrangement.

2. *Cash Balance Conversions and Early Retirement*

A similar source of controversy is the impact of a cash balance conversion when the final average plan replaced has offered "subsidized" early retirement benefits.[52] In this case also, the conversion harms employees on the verge of accruing significant pension benefits by terminating the conventional plan just before such employees experience particularly valuable years of pension coverage.

Conventional defined benefit plans can offer early retirement benefits on an "unsubsidized" basis, i.e., by beginning benefits earlier, but reducing the annual quantum of such benefits to recognize that pay out has commenced sooner and therefore will be spread over a longer remaining life expectancy than if benefits had instead begun later, upon the employee's attainment of the plan's normal retirement age.

Consider, for example, a fifty-five year-old participant in a final average plan who has accrued a normal retirement annuity of $20,000 per year starting ten years hence at age sixty-five. Suppose that the plan has an unsubsidized early retirement provision: the fifty-five year-old employee, since she has the required twenty-five years of service with the employer, need not wait until normal retirement to receive her benefit but can instead accelerate her pension and start receiving it now. Because, however, this early retirement option is not employer-subsidized, the employee receives no bonus for retiring earlier but merely

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[52] *See* MCGILL ET AL., *supra* note 21, at 215-18.

receives her payments spread out over a longer period.

In this case, the employee's unsubsidized annual benefit starting at age fifty-five will only be $6877 per year.[53] This lower annual annuity amount recognizes that payments will begin ten years earlier than normal retirement and will accordingly last ten years longer than if the employee had waited to age sixty-five to start collecting retirement benefits. From the employer's perspective, this early retirement option is essentially costless since, in present value terms, the plan has simply inaugurated ten years earlier the same stream of payments the plan would have made at normal retirement.

By the same token, from the employee's perspective, this unsubsidized early retirement does not increase her net anticipated pension benefit for her remaining lifetime since the earlier commencement of retirement payments is counterbalanced by the lower amount of each annual payment. Thus, unsubsidized early retirement is simply a matter of timing and does not entail any increase in the employee's overall pension wealth: $6877 per year starting at age fifty-five is, in present value terms, identical to $20,000 per year delayed until age sixty-five.

In contrast, "subsidized" early retirement augments a qualifying employee's pension wealth by allowing her to start her payments earlier without a full offset for that earlier commencement. The upshot is a stream of payments over the employee's remaining lifetime that is particularly valuable since that stream is not reduced on an annual basis to reflect its earlier start.

Suppose, for example, the plan subsidizes early retirement by permitting a fifty-five year-old employee with twenty-five years of service to receive her normal retirement annuity immediately with no reduction in the annual amount to reflect the earlier commencement of that annuity. In this case, to continue the example, the employee could begin to receive the full $20,000 per

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[53] At normal retirement age 65, the $20,000 annual annuity due the employee will have a lump sum present value of $183,920, i.e., $20,000 x 9.196. Discounting that lump sum to age 55, produces a present value at age 55 of $85,191 (i.e., $183,920/(1.08)^10). At age 55, it costs $12.3874 to produce $1 of annuity income for each year of the rest of the employee's life. Hence, the unsubsidized early retirement benefit is $6877 (i.e., $85,191/12.3874). The purchase rate of $12.3874 comes from a well-known table, 83-GAM Table at six percent.

year starting at age fifty-five.

From the employer's perspective, the alternative of full pension benefits starting ten years early is costly. In this case, permitting the employee to receive the entire $20,000 per year annuity at age fifty-five, rather than discounting that annuity to reflect its earlier commencement, costs the plan (and, thus, ultimately the employer which funds the plan) $247,748,[54] $162,557 more than the expense of the unsubsidized early retirement option.[55] From the employee's perspective, this extra cost (the early retirement subsidy) is an employer-provided gross-up of her pension benefits awarded as a bonus for satisfying the plan's early retirement criteria, in this case, the attainment of age fifty-five and the completion of twenty-five years of service with the employer. In simple terms, subsidized early retirement can be valuable for the employee since her benefit begins early but without full reduction to reflect its early commencement.

The relationship between cash balance conversions and subsidized early retirement is illustrated by considering a fifty-three year-old employee who, two years shy of satisfying the plan's early retirement requirements, is informed that the traditional final average plan is terminated and replaced by a cash balance arrangement. Just as she can peer into the promised land of subsidized early retirement, the employee's right to earn that benefit is snatched away by the termination of the traditional pension (with its subsidized early retirement option) and its replacement by a new cash balance arrangement.

For this employee, the years just before the attainment of a subsidized early retirement benefit are similar in their impact to the late career years of an older employee edging up on normal retirement. In both instances, if the traditional plan is continued, these years will significantly enhance the employee's retirement income. And, in both cases, the conversion to a cash balance method deprives the employee of the opportunity to experience those last few valuable years under the traditional pension formula.

Just as employers can mitigate the effect of cash balance

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[54] Calculated as follows: $20,000 x 12.3874 = $247,748.

[55] Calculated as follows: $247,748 - $85,191 = $162,557.

conversions on employees near normal retirement, employers can ameliorate the effect of the cash balance conversion on participants approaching early retirement. In our example, the employer could, for instance, permit any employee over age fifty to participate for another five years in the final average plan. Or the employer could credit all employees aged fifty-three with the additional two years necessary to qualify for subsidized early retirement benefits under the old plan.

However, in the absence of these or other ameliorative measures, the employee on the cusp of subsidized early retirement will find, on the conversion to the cash balance motif, that her pension wealth has been reduced by the conversion in comparison to the entitlement she would have earned had she been allowed to accrue a subsidized early retirement pension.[56]

3. *Wear-Away Provisions*

A third source of controversy has been the feature of some cash balance plans commonly known as "wear-away." Under this approach, a new defined benefit plan specifies an employee's accrued benefit as the greater of her benefit under the old method, frozen as of the institution of the new plan, or the employee's notional account under the new cash balance configuration. In some instances, that account will, upon commencement of the new formula, start at zero. Alternatively, the employee's notional account under the cash balance format can be calculated by applying the new method retroactively to the beginning of the employee's plan participation. Either way, after the cash balance conversion, the employee's actual pension entitlement does not grow until her hypothetical account balance under the cash balance methodology equals ("wears away") and begins to exceed the value of the benefit she had earned previously under the traditional pension formula. The upshot is that, for the initial

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[56] *See, e.g.*, Raymond J. Lee & William P. Bishop, *Trends in Pensions – Hybrid Pension Plans*, 29 PENSION ACTUARY No. 2, Mar.-Apr. 1999, at 4, 18 ("A properly designed hybrid plan can, over time, effectively eliminate the early retirement subsidy, yet keep the availability of an early retirement incentive program within the plan."). Cash balance plans are frequently denoted "hybrid" arrangements because they partake of both the defined contribution and the defined benefit formats.

years of the cash balance arrangement, the employee does not accrue any additional pension wealth as her hypothetical account under the cash balance motif is just catching up with her previously accrued benefit from the old plan.

Assume, for example, that under a traditional final average formula an employee with ten years of service has earned an annuity benefit which, when discounted to present value, is worth $50,000. Assume further that the employer now amends the plan to embrace a cash balance method and that, when this method is applied retroactively, the employee is entitled to a hypothetical account balance of $40,000 based on her prior years of service and salary. Under the wear-away approach, the employee's accrued benefit remains frozen at the $50,000 from the prior traditional formula until, at some point in the future, her cash balance entitlement, calculated from the beginning of her employment, catches up and starts to exceed this previously earned amount.

In this context, it may take several years for the cash balance formula (applied retroactively) to catch up with ("wear-away") the amounts previously accrued under the old traditional approach. If the employee's account balance simply started at zero, the wear-away period would be even longer since it would take more time for her account balance to reach and exceed the employee's frozen benefit ($50,000) from the old formula.

At one level, the participant is not hurt by the wear-away method since her accrued benefit is, per statutory mandate,[57] not reduced by the formula embodied in the new cash balance plan, merely frozen at its pre-existing level. On the other hand, the participant's initial years of participation under the cash balance approach yield no economic benefit to her since, in those years, her new notional account under the cash balance formula is merely catching up with the level of benefits she already earned under the traditional annuity method.

Wear-away methods are particularly sensitive to the actuarial assumptions used to convert accrued annuities earned under traditional formulas to lump sum values. In the example just cited, the translation of the conventional annuity benefit to a lump sum

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[57] *See* I.R.C. § 411(d)(6)(A); *see also* ERISA § 204(g).

depends inter alia upon the interest rate used to commute annual payments into their present value. Suppose, for example, that the plan postulates a higher interest rate, and thus, lowers the calculated value of the employee's annuity accrued under the final average plan. Assume, for instance, that the plan increases its interest rate assumption so that the value of the employee's traditional benefit, expressed as a lump sum, declines to $40,000 while her opening account balance, calculated retroactively to the beginning of her plan participation, remains at $40,000. In such a case, for this employee the wear-away disappears since the reformulated lump sum equivalent of her annuity ($40,000) equals her retrospectively created account balance (also $40,000), eliminating the need for that account balance to catch up with her previously-earned annuity. Thus, the employee starts to accrue benefits under the cash balance plan immediately since there is no longer a gap between the accrued annuity previously earned and the cash balance account constructed retroactively.

By the same token, if the plan presumes a lower interest rate, which elevates the value of the employee's accrued annuity payments to a lump sum of $60,000, the employee's wear-away period is elongated since more ($20,000) must be added to her retroactive account balance ($40,000) before it catches up to the benefit already earned under the old formula. This example is even more dramatic when the employee's opening notional account balance is set at zero. In this case, it takes even longer for her cash balance entitlement, starting at $0, to reach and exceed her previously earned benefit under the old plan calculated as a lump sum using lower interest rate assumptions (i.e., $60,000).

E. Employer Motives for Abandoning Final Average Formulas

1. Employer Motives for Embracing the Defined Contribution Motif

Why would an employer abandon a traditional final average formula for the *ersatz* defined contribution approach of a cash balance arrangement? Initially, we can identify three reasons why an employer would embrace the defined contribution motif and

three further reasons why an employer would prefer the *ersatz* defined contribution configuration of a cash balance arrangement over a true defined contribution plan.

First, the conversion from a final average formula to a defined contribution method of determining pension entitlements can reduce the employer's aggregate pension costs. Second, such a conversion reorients pension benefits from older to younger workers. Third, the proponents of cash balance plans maintain that employees today understand the language and operation of individual accounts better than traditional, annuity-based formulas and find such accounts more compatible with mobility between employers.

To explore the potential reduction of employer contributions on conversion from defined benefit to defined contribution formulas, let us compare the economics of a small, two participant defined benefit plan, first, as a final average arrangement and, then, as a cash balance plan. For this example, assume the plan covers a thirty-five year-old employee in her first year of employment[58] and a sixty-two year-old employee entering her eighteenth year of employment. Let us also assume that the plan utilized a traditional final average formula for the last seventeen years along the lines postulated previously, i.e. the plan pays a retirement annuity at age sixty-five of fifty percent of final average salary times a years of service fraction, the numerator of which is the participant's actual number of years of service and the denominator of which is thirty. Suppose further that the young employee's salary for her first year of employment is $20,000, that the older employee has, for the prior three years, earned $40,000 annually, and that, for the year in question (the older employee's eighteenth year of service in which she turns age 62), the older employee's annual salary increases to $46,000 yearly.[59] Finally, suppose that the alternative to the continuation of the traditional final average salary method is the institution of a cash balance

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[58] The plan could exclude the employee for her first year of employment. *See* I.R.C. § 410(a)(1)(A); *see also* ERISA § 202(a)(1)(A). However, the example is simpler if immediate participation in the plan is assumed. Like other simplifications, this one does not affect the substance of the analysis.

[59] Again, these are simplified assumptions that make the arithmetic easier without affecting the substance of the conclusions.

formula consisting of a pay credit of ten percent of salary and an interest credit at five percent.

If the final average salary formula remains in effect for this year, the young employee will, for her first year of pension participation, earn a deferred annuity of $333 starting thirty years hence.[60] This annuity will have a present value of $304,[61] the amount the employer must fund currently. If, alternatively, the employer switches to the cash balance motif for this year, the employer will be obligated to fund a theoretical account balance of $2100 for the young employee.[62] Thus, in this example, the cash balance approach is $1796[63] more valuable for the young employee and equally more expensive for the employer.

As to the older employee, if the traditional average formula remains in effect, her promised annuity will increase during this year from $11,333[64] to $12,600,[65] necessitating an employer contribution of $9249.[66] As has been emphasized previously, it is expensive to provide traditional pension annuities for older workers since such older workers tend to be better paid, have higher years of service fractions as a result of greater seniority, and are relatively close to retirement, leaving comparatively little time for employer contributions to grow via investment gain.

In contrast, if, for this year, the employer switches to the cash balance motif, its outlay for the older worker will only be $4830,[67] a saving to the employer of $4419.[68] Thus, while the switch to the cash balance formula increases the employer's contributions for the younger employee, the employer saves a net of $2623[69] by

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[60] Calculated as follows: $20,000 x 1/30 x 0.5 = $333.

[61] Calculated as follows: $333 x 9.196/1.08^30 = $304.

[62] Calculated as follows: (0.10 x $20,000) + (0.05 x $2,000) = $2100.

[63] Calculated as follows: $2100 - $304 = $1796.

[64] Calculated as follows: [($40,000 + $40,000 + $40,000)/3] x 0.5 x 17/30 = $11,333.

[65] Calculated as follows: [($46,000 + $40,000 + $40,000)/3] x 0.5 x 18/30 = $12,600.

[66] The present value of the annuity earned by the employee in her first seventeen years is, at the beginning of this year, $82,732 (i.e., $11,333 x 9.196/1.08^3). As of the beginning of the year, the value of the annuity the employee would earn during such year under the traditional formula is $91,981 (i.e., $12,600 x 9.196/1.08^3). If the final average formula remains in effect for this additional year, the employer must fund the difference: $91,981 - $82,732 = $9249.

[67] Calculated as follows: (0.10 x $46,000) + (0.05 x $4600).

[68] Calculated as follows: $9249 - $4830 = $4419.

[69] Calculated as follows: $4419 - $1796 = $2623.

shifting to the cash balance approach. With the change to a defined contribution method (either a true individual account plan or the pseudo-defined contribution approach of a cash balance arrangement), a plan no longer provides expensive annuities for more senior plan participants, enabling the employer to reduce its overall plan contributions even as the employer contributes more for younger workers.

Moreover, the replacement of traditional defined benefit formulas with defined contribution methods (either a true individual account plan or the pseudo-defined contribution configuration of the cash balance approach) reorients the employer's pension plan towards younger workers even if the employer achieves no overall contribution reduction since young workers' pension entitlements typically climb as a result of the conversion to defined contribution formulas while older participants' entitlements decrease. Hence, generational redistribution occurs even if the employer keeps its aggregate pension costs the same as they were under the final average formula. Because a defined contribution approach does not entail age-related expense for older workers, such an approach reorients the plan towards younger participants.

To see this, suppose now that the employer foregoes the opportunity to reduce its aggregate pension costs and, under the new defined contribution method, commits to spending the same $9553[70] that the employer would have spent under the final average formula. In this case, each employee receives an allocation of 14.47% of salary[71] – an allotment of $2894[72] to the younger employee (a significant increase over the employer's contribution under the traditional final average salary formula)[73] and an allocation of $6657[74] for the older worker (a significant decline from the employer's contribution under the traditional defined benefit plan).[75] Thus, holding the employer's aggregate contribution steady and shifting to a defined contribution formula

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[70] Calculated as follows: $304 + $9249 = $9553.
[71] Calculated as follows: $9,553/($20,000 + $46,000) = 14.47%.
[72] Calculated as follows: 14.47% x $20,000 = $2894.
[73] Specifically, $304 compared to $2894.
[74] Calculated as follows: 14.47% x $46,000 = $6657.
[75] Specifically, $9247 compared to $6657.

releases funds previously committed to the expense of providing annuity benefits for the older worker and reallocates these funds instead to the younger plan participant.

This analysis, in turn, raises the issue of underlying employer motivation: why would the employer want to reorient its plan from older to younger workers? The apparent answer – to attract and retain younger employees via greater pension benefits – is, on second thought, not so obvious. For many younger persons, retirement is a distant abstraction and enhanced retirement income a correspondingly illusive benefit. On the other hand, for older workers the reality of retirement is far more pressing.

This suggests that, in at least in some cases, the employer's motivation to switch from defined benefit to defined contribution formulas is less to attract younger workers than to decrease the value of future pension accruals to older employees. Yet, even here, the story may be more complex than first appears. For some employers, reducing the value of older employees' future pension participation may be a way of shedding such older employees by decreasing their remuneration from continuing to work. However, in other cases, reducing the value of further participation in the employer's defined benefit arrangement may be a strategy to retain older employees. If, for example, bull market conditions have elevated such employees' 401(k) accounts to the point where early retirement is becoming economically viable for them, reducing future defined benefit accruals can be a strategy for counterbalancing the employees' 401(k) wealth and thus providing an incentive for them to continue working.

Underlying the employer's resolve to divert pensions away from older workers is the diminished personal significance to senior corporate decision makers of qualified pension plans. Over the years, Congress has reduced and limited the qualified pension benefits which high-income employees can earn.[76] At the same time, nonqualified forms of compensation such as stock options,

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[76] Among the most significant provisions are sections 401(a)(17) (capping the employee compensation "taken into account" for pension purposes) and 415(b) (limiting the annual amounts payable by defined benefit plans). *See generally*, Vincent Amoroso et al., *Deductible Limits For Qualified Pension Plans: Yesterday, Today, And Tomorrow*, NYU PROC. 57TH INST. ON FED. TAX'N – EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION § 1.01 (Alvin D. Lurie ed. 1999).

"top hat" retirement plans,[77] and current salary have risen to levels unimaginable in an earlier age.[78] The upshot is that older corporate managers can, with equanimity, reduce future pension accruals for older workers since such pensions are a relatively minor portion of those managers' own compensation packages.

A third explanation for the shift from defined benefit plans to the defined contribution approach is the oft-stated claim that account balances are both easier for employees to understand than are traditional defined benefit formulas and are more compatible with a world of great employee mobility. This claim is discussed below in Part V(C). At this point, it should be noted that commentators disagree whether the perception of increased employer mobility corresponds to the reality of the labor market.[79]

2. *Employer Motives for Adopting Cash Balance Arrangements Rather Than True Defined Contribution Plans.*

This initial set of explanations for the conversion from defined benefit to defined contribution methodologies prompts a second inquiry: why don't employers simply adopt true defined contribution plans? If the employer is motivated by any or all of these three considerations the employer can terminate its existing defined benefit arrangement and adopt a new defined contribution

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[77] *See, e.g.*, *Executive Compensation: KPMG Survey Of Executive Plans Shows Prevalence Among Big Companies*, PENS. & BENEFITS DAILY (BNA), Nov. 19, 1999 ("Of the 139 companies that responded to the survey, 97 percent offer top-hat or excess [supplemental executive retirement] programs as a way to retain management and other key personnel . . . .").

[78] *See, e.g.*, Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867 (1992); Charles M. Yablon, *"Bonus Questions – Executive Compensation in the Era of Pay for Performance,"* 75 NOTRE DAME L. REV. 271 (1999).

[79] Those examining historic data tend to conclude that the perception of increased employee mobility is overstated while those looking at current attitudinal surveys tend to confirm the impression of a workforce less anchored to jobs and employers. *Compare* MCGILL ET AL., *supra* note 21, at 344-48 (data "do not seem to support the perception that the work force has become more mobile in recent decades") *with Never Satisfied*, WALL ST. J., Feb. 8, 2000, at 1 ("Forty percent of 1,383 employees polled for CareerPath.com, an Internet newspaper-jobs site, say they are likely to change jobs this year."). *See also* 32 BAKERY PRODUCTION AND MARKETING NEWSLETTER No. 7, Feb. 14, 2000, at 3 ("The poll also showed that tenure is not in most employees' vocabulary. Only one in three have held the same job for five years, and one in five are on their fourth or higher job in five years. Nearly half of all respondents have an updated resume ready to distribute at a moment's notice.") (available from author).

plan which responds to any or all of these concerns. Why instead modify the existing defined benefit plan to the pseudo-defined contribution approach of the cash balance method?

Here, again, three factors suggest why employers elect to convert defined benefit plans to cash balance arrangements rather than terminating their defined benefit plans altogether and replacing them with true defined contribution arrangements. First, the termination of a defined benefit plan preparatory to its replacement with a true defined contribution arrangement vests participants in accrued but previously forfeitable benefits. In contrast, no termination-related vesting occurs on the conversion of a defined benefit plan from a traditional final average formula to a cash balance configuration since, under current law, this is considered the modification and continuation of the pre-existing plan.

All employees, regardless of the length of their respective employments, vest on plan termination.[80] Assume, for example, that an employer maintaining a conventional defined benefit plan uses five-year "cliff" vesting under which an employee leaving employment prior to the completion of five years of service forfeits the pension benefits she has earned.[81] Assume further that this employer experiences significant and predictable turnover of its labor force and that, consequently, the forfeiture of unvested benefits by employees leaving before they have worked for five years plays an important role in controlling the employer's pension costs. The funds contributed to finance forfeited benefits are freed to cover the expense of benefits to be earned by other participants in the future, subject to the possibility that such funds will be recycled yet again when others leave before completing the five years of service necessary to vest.

On the termination of the employer's defined benefit plan, all benefits of participants with less than five years of service are vested in the benefit accrued to date even though many of these employees would, in the normal course, have forfeited these benefits by leaving employment before the completion of five years of service. In contrast, the conversion of this defined benefit plan

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[80] *See* I.R.C. § 411(d)(3).

[81] *See* I.R.C. § 411(a)(2)(A); *see also* ERISA § 203(a)(2)(A).

from a traditional final average formula to a cash balance design does not terminate the plan, but continues the plan with a different method of calculating benefits. An unvested employee before the conversion to the cash balance method remains unvested after that conversion since there has been no plan termination, just a modification and continuation of an existing plan. If the unvested employee quits her employment within five years of hire, she forfeits the benefits she accrued both before and after the conversion, thus freeing for reuse the funds financing her now-forfeited pension benefit.

Second, the termination of an amply-funded defined benefit plan and its replacement by a true defined contribution arrangement triggers the reversion tax provisions of section 4980; by contrast, the conversion to the cash balance method does not implicate section 4980.

Consider a defined benefit plan that is overfunded, i.e., one which has more funds than necessary to pay benefits owed to participants. Such overfunding generally[82] results from either superior investment performance by the plan's assets or from deliberate pre-funding of projected benefits. Suppose, for example, that the plan's actuary assumed that plan assets would earn a five percent return when the assets in fact earn a ten percent return. In that case, if all of the actuary's other assumptions were accurate, the plan, at the end of the year, has surplus funds on hand as a result of its better than expected investment performance.

Or assume that, to mitigate the heavy financial demands of funding late-career benefits, the employer pre-funds such benefits earlier.[83] In this case, the actuary projects future benefits and then determines the level funding amount necessary to finance such benefits. In this situation, the plan's resources are currently

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[82] Overfunding can also result from other types of actual experience which prove more favorable financially than had been anticipated. For example, if fewer employees are disabled than the plan's actuaries had projected, a pension plan providing disability benefits will have funds left over from anticipated, but unpaid, disability benefits.

[83] The employer's ability to pre-fund is not without limit. *See* I.R.C. § 412(c)(7). The Code's full funding limit has been a source of considerable controversy. *See* JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 285-88 (2d ed. 1995). *See also* Amoroso et al., *supra* note 76, § 1.04.

greater than necessary to finance benefits which employees have earned to date since those resources, by design, include additional amounts to pre-fund anticipated (but not yet earned) benefits.

In either case, the defined benefit plan, if terminated, has surplus assets, i.e., assets greater than those necessary to pay the pension benefits actually owed today on the plan's termination. Before the adoption of section 4980, the employer generally recouped this surplus (denoted pension "reversion"), paid regular income tax on the amounts recovered from the terminated plan,[84] and then used the remainder of the reversion for the employer's general purposes. Thus, before section 4980, the termination of an overfunded defined benefit plan and its replacement by a true defined contribution arrangement generally entailed fairly benign tax consequences for the employer.

Section 4980, however, transformed the regulatory environment for reversions from defined benefit terminations, creating three alternatives, each of which impairs significantly the employer's ability to utilize surplus defined benefit assets for its own purposes. In the absence of an employer's decision to the contrary, the employer who today terminates its defined benefit plan and takes a pension reversion of surplus assets pays regular income taxes on that reversion and also, per section 4980, pays a tax surcharge of fifty percent.[85] In this case, when the employer terminates its defined benefit plan and starts a new defined contribution plan, the reversion is essentially absorbed by federal taxes.[86]

Alternatively, the employer terminating its defined benefit plan to replace such plan with a defined contribution arrangement pays regular income taxes on the reversion from the terminated defined benefit pension and, under section 4980, can choose to donate twenty-five percent of the reversion to the new defined contribution plan. In this case, the employer also pays a twenty percent tax surcharge on the reversion – another scenario in which the reversion yields little financial benefit for the employer

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[84] These amounts represent previously deducted employer contributions as well as plan earnings accumulated tax-free in the pension trust.

[85] I.R.C. § 4980(d)(1).

[86] The regular income taxes generated by plan reversions may be offset by net operating losses or other income tax deductions.

switching from defined benefit to defined contribution arrangements.

Finally, section 4980 gives the employer a third alternative when terminating an overfunded defined benefit plan: pay regular income tax on the reversion, increase benefits in the terminated defined benefit plan by twenty percent of the reversion, and pay an additional twenty percent tax on the reversion. Again, this is a scenario in which the employer derives little financial benefit from the reversion when terminating an overfunded defined benefit pension and replacing it with a new defined contribution arrangement.

In this context, the cash balance approach is a means of avoiding section 4980, a way of switching from defined benefit to defined contribution methods without triggering either of the three regimes embodied in section 4980. The conversion of a final average formula to a cash balance configuration is not a termination of a defined benefit plan, but, under current law, is the continuation of the preexisting plan with a different benefit formula. Consequently, the surplus assets of the defined benefit plan remain intact within the plan, now switched to the cash balance approach. A cash balance conversion does not trigger section 4980 because the overfunded defined benefit plan is not terminated, just modified to the *ersatz* defined contribution methodology of the cash balance approach. The employer, via the cash balance conversion, thus switches from a classic defined benefit method of determining retirement benefits to something akin to a defined contribution method but (notwithstanding section 4980) still profits from surplus plan assets since that surplus reduces the employer's outlays from its own resources under the new cash balance formula.

From this perspective, it is no accident that conversion to cash balance methods became popular during the bull market of the 1990s. If employers had terminated their amply-funded defined benefit plans and replaced them with true defined contribution arrangements, employers would have thereby subjected surplus plan assets to section 4980.[87] In contrast, switching to the cash

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[87] *See* I.R.C. § 4980; *see also supra* pp.30-33 (for a discussion of the effects of section 4980).

balance design does not trigger section 4980 (since the defined benefit plan is merely modified, not terminated), but gives the employer a result similar to the termination of its final average plan and its replacement with a defined contribution arrangement.[88] In simple terms, the cash balance plan is a response to the regulatory environment created by section 4980.

This analysis suggests that conversions to cash balance formulas are, in important measure, motivated by the existence of surplus assets in conventional defined benefit pension plans. However, it overstates to characterize such conversions as simple appropriation of surplus pension assets by the converting employers.[89] When amply-funded defined benefit plans switch to the cash balance approach, surplus assets stay in the plan to provide benefits for employees. However, insofar as cash balance formulas reorient plans from older to younger workers, such surplus assets are effectively channeled from older to younger participants.[90] Moreover, insofar as the conversion to the cash balance motif is an occasion for reducing the employer's pension costs, that conversion stretches the indirect benefit to the employer of the surplus by reducing the employer's overall funding obligation and thereby lengthening the number of years that the employer need not contribute to the plan because the surplus is funding new accrued benefits.[91]

A third reason an employer might prefer the pseudo-defined contribution approach of a cash balance formula to a true defined contribution plan is that the employer wants to keep the benefits of superior investment performance for itself. In a true defined contribution setting, the employee is entitled to her account balance – whatever it might be. Consequently, superior investment performance redounds to the employee's advantage and the risk of loss falls on the employee's account balance. A risk averse employer may prefer to shift the advantages and dangers

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[88] *See id.*

[89] *See, e.g.*, Janet Krueger, *IBM Employee Coalition's Testimony At Senate Hearing On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-19, ¶ 22) ("If you allow these billions of excess dollars to be diverted from our pension funds, they will be gone, and irretrievable.").

[90] *See supra* pp. 26-27.

[91] *See supra* pp. 24-26.

of investment experience to its employees via a genuine defined contribution arrangement.

However, not all employers are risk averse. Before the advent of the cash balance plan, an employer seeking to retain for itself the benefits of superior investment performance was required also to retain the other features of a conventional defined benefit plan. However, under the hybrid cash balance arrangement, the employer retains the risk and rewards of investment experience (since the plan is a defined benefit arrangement) while simultaneously gaining the other putative advantages of a defined contribution world, i.e., lower costs, reorientation of benefits toward younger workers, greater comprehension, better adaptation to a mobile workforce.[92]

III. THE LEGAL FRAMEWORK

In this Part, the legal framework governing cash balance pension plans is discussed. In particular, those portions of the Code, ERISA and the Age Discrimination in Employment Act (ADEA) which affect cash balance plans, as well as the Treasury's pronouncements about cash balance plans, are discussed.[93] Specifically, five statutory provisions (and the regulations under such provisions) bear directly upon cash balance arrangements: (1) the Code's requirement that qualified plan benefits or contributions not discriminate in favor of highly compensated employees;[94] (2) the Code and ERISA's regulation of the rate at

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[92] An additional consideration is that cash balance plans, as defined benefit arrangements, are generally insured by the Pension Benefit Guaranty Corporation (PBGC) for basic benefits while true defined contribution plans are not PBGC insured. ERISA § 4001(a)(15) (single employer plan for purposes of Title IV "means any defined benefit plan..."). On the one hand, the premiums for PBGC coverage may be viewed as a disadvantage, a cost that can be avoided by shifting to genuine defined contribution arrangements. On the other hand, employees and employers may view the PBGC's insurance program as a boon and thus a reason to prefer the cash balance format over the true defined contribution motif.

[93] Of course, the entire statutory and regulatory framework governing qualified plans applies to cash balance arrangements. However, as to much of this framework, no unique issues arise in the cash balance context. Thus, for example, all ERISA-regulated plans must be reduced to writing. *See* ERISA § 402(a)(1). Cash balance plans do not raise issues as to this writing requirement. Therefore, such statutory requirements are not discussed here.

[94] *See* I.R.C. § 401(a)(4).

which defined benefit participants must accrue their respective benefits;[95] (3) the Code and ERISA provisions relative to actuarial assumptions and lump sum distributions;[96] (4) statutory prohibitions on age-based reductions in the rate of defined benefit accruals;[97] and (5) ERISA's requirement that participants receive notification of plan amendments which significantly reduce the rate of future benefit accruals.[98]

A. Nondiscrimination As to Benefits or Contributions

The Code mandates that qualified plan benefits or contributions not discriminate in favor of highly compensated employees.[99] The Code itself provides minimal guidance as to the content of this nondiscrimination requirement:[100] benefits or contributions proportional to compensation (e.g., ten percent of every employee's salary) are not discriminatory;[101] benefit and contribution formulas which properly account for the federal social security system are not discriminatory;[102] plans which distinguish between clerical and salaried workers are not discriminatory per se though they may in fact discriminate in favor of highly compensated employees.[103] Beyond these statutory basics, the meaning of the Code's requirement that qualified plan benefits or contributions not discriminate in favor of highly compensated employees had, prior to 1994, been developed through case law[104] and administrative rulings.[105]

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[95] *See* I.R.C. § 411(b); *see also* ERISA § 204.

[96] *See* I.R.C. §§ 401(a)(25), 411(a)(11)(A), 417(e)(1); *see also* ERISA §§ 203(e), 205(g)(1), (2).

[97] *See* I.R.C. § 411(b)(1)(H)(i); *see also* ERISA § 204(b)(1)(H)(i); ADEA § 4(i)(1)(A).

[98] *See* ERISA § 204(h).

[99] I.R.C. § 401(a)(4).

[100] For purposes of this discussion, it is important to reiterate that, in this context, the issue is not age discrimination, which is discussed *infra* Part III(D), but discrimination in favor of highly compensated employees.

[101] I.R.C. § 401(a)(5)(B).

[102] I.R.C. § 401(a)(5)(C), (D).

[103] I.R.C. § 401(a)(5)(A).

[104] *See, e.g.*, Commissioner v. Pepsi-Cola Niagara Bottling Corp., 399 F.2d 390 (2d Cir. 1968). For contemporary comment on *Pepsi-Cola*, see generally Alvin D. Lurie, *Coping with IRS' Tough Tests for Salaried-Only Plans in the Post-Pepsi Period*, 32 J. TAX'N 24 (Jan. 1970).

[105] *See, e.g.*, Rev. Rul. 81-202, 1981-2 C.B. 93.

Effective January 1, 1994, the Treasury promulgated detailed Regulations interpreting the Code's nondiscrimination mandate.[106] Two features of those Regulations provide important background to the cash balance controversy. First, the Regulations provide safe harbors under which certain plans are nondiscriminatory per se by virtue of the plans' designs.[107] In such cases, there is no need to review the actual distribution of benefits or contributions among particular plan participants since the plans' designs are deemed to be inherently nondiscriminatory. Alternatively, plans which, on their face, are not necessarily nondiscriminatory may, in their actual operation, prove acceptable by examining the actual distribution of benefits or contributions to particular employees and by determining that, in practice, the distribution of benefits or contributions does not favor highly compensated employees.

Thus, for example, an individual account arrangement under which each participant receives a contribution equal to ten percent of her salary is, by its design, nondiscriminatory as to highly compensated employees since all employees automatically receive a contribution which is the same proportion of their salary. There is, therefore, no need to look at the allocations to specific participants to confirm the absence of favoritism towards highly compensated employees.[108] Similarly, a defined benefit plan which grants each employee $20 of annuity income for each month worked, by its design, does not favor highly compensated employees since each month of pension coverage yields the same retirement income for all employees.[109]

In contrast, a formula which awards each employee a current contribution of one percent of her salary for each of her past years of service is not, on its face, necessarily nondiscriminatory as to highly compensated employees since such employees may have greater seniority than rank-and-file participants. In that case, the highly compensated members of the work force (because of their greater seniority and, hence, their higher contribution percentages) would receive proportionately greater retirement

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[106] *See* Treas. Reg. § 1.401(a)(4).

[107] *See, e.g.*, Treas. Reg. § 1.401(a)(4)-2(b)(2) (defined contribution safe harbor for uniform allocation formulas).

[108] *See id.*

[109] *See* Treas. Reg. § 1.401(a)(4)-3(b)(4)(i)(C)(2).

contributions relative to their respective salaries than would their lower paid colleagues. However, in operation, such a seniority-based formula may prove nondiscriminatory if, for example, in practice all employees have twelve years of service and thus each employee (including those not highly compensated) receives a contribution of twelve percent of her respective salary. However, such a determination requires analysis beyond the terms of the plan to examine the actual contributions to each employee.

Second, plans may be "cross-tested" to determine if they discriminate in favor of highly compensated employees.[110] A defined benefit plan may be tested for discrimination by comparing the annuity benefits promised each participant with each participant's respective compensation. Thus, for example, a plan which promises each employee an annuity of twenty percent of final average salary is nondiscriminatory since the annuity benefit specified by the plan is proportional to each employee's respective compensation. Similarly, a defined contribution plan may be screened for prohibited favoritism towards the highly compensated by comparing the employer's contribution for each employee with her respective salary.

However, under the Regulations' cross-testing alternative, defined benefit plans may be assessed by looking, not to promised benefits, but to contributions, in particular, by translating promised benefits into current contributions and determining whether such contributions (not the specified annuity) are nondiscriminatory.[111] Similarly, under the cross-testing alternative, whether a defined contribution plan discriminates in favor of highly compensated employees is determined, not by examining the pattern of plan contributions, but by converting those contributions into equivalent annuity benefits and by inferring the existence of discrimination *vel non* from the pattern of such benefits.[112]

Under the Regulations, cash balance plans (defined benefit arrangements) may cross-test for nondiscrimination by examining the actual allocation of contributions among participants to

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[110] *See generally* LANGBEIN & WOLK, *supra* note 83, at 233.

[111] *See* Treas. Reg. § 1.401(a)(4)-8(a), (c).

[112] *See* Treas. Reg. § 1.401(a)(4)-8(a), (b).

determine if such contributions in practice discriminate in favor of highly compensated employees.[113] Alternatively, the Regulations provide a design-based cross-testing safe harbor under which cash balance plans are per se nondiscriminatory as to highly compensated employees if such plans contain certain features. For example, under this design-based safe harbor, cash balance plans may allocate to each employee's hypothetical account the same percentage of salary or the same dollar amount for all employees.[114] Similarly, to qualify for the design-based safe harbor, a cash balance plan, in determining hypothetical plan earnings, must use a single "standard interest rate" for all participants or must use one of several approved variable interest rates.[115]

With one exception, the nondiscrimination[116] Regulations have not been controversial as to cash balance plans and provide an objective, often complex, path for such plans to comply with section 401(a)(4) and its mandate that contributions or benefits not favor highly compensated employees. The exception is the Regulation's approval of wear-away methods in assessing whether plans discriminate against rank-and-file employees.[117] As we shall see, wear-away formulas have engendered considerable controversy in the cash balance context.[118]

B. Accrued Benefit Rules

In essentially identical terms, the Code and ERISA regulate the rate at which participants earn their retirement entitlements

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[113] *See* Treas. Reg. § 1.401(a)(4)-8(c)(3)(i) ("Because a cash balance plan is a defined benefit plan, whether it satisfies section 401(a)(4) with respect to the equivalent amount of contributions is generally determined under paragraphs (c)(1) and (c)(2) of this section..." pertaining to cross-testing of defined benefit plans).

[114] *See* Treas. Reg. § 1.401(a)(4)-8(c)(3)(iii)(B).

[115] *See* Treas. Reg. § 1.401(a)(4)-8(c)(3)(iv).

[116] To repeat, at this point, we are discussing nondiscrimination as to highly compensated employees, not age discrimination.

[117] *See* Treas. Reg. § 1.401(a)(4)-413(c)(4). Note that the regulations condone wear-away formulas under the rubric of section 401(a)(4) and nondiscrimination as to highly compensated employees. The Regulations say nothing about wear-away formulas in the context of age discrimination.

[118] *See, e.g.*, Colleen Congel, *Harkin Seeks To Broaden Support For Bill Targeting Age Discrimination Violations*, DAILY TAX REP. (BNA), Sept. 16, 1999, at G-3.

under defined benefit arrangements.[119] The purpose of these provisions is to prevent excessive backloading (i.e. postponing) of accrued benefits. As we have seen,[120] a certain amount of backloading is inherent in conventional defined benefit arrangements. Older participants tend to earn more of their traditional annuity-type benefits in their later years because these are their years of highest salary and greatest seniority as well as years proximate to retirement. On the other hand, the Code and ERISA preclude more egregious forms of backloading.[121]

Consider, in this context, the extreme (but heuristically useful) possibility that a defined benefit plan would provide an annuity at retirement equal to fifty percent of the employee's final average salary, but that the benefit would accrue at the rate of one dollar per year of service until age sixty-five when the entire remaining balance of the benefit would be earned in one fell swoop. Suppose further that a sixty-four year-old employee has been making $40,000 per year, has twenty years of service, and terminates her employment one year short of the normal retirement age of sixty-five.

In this theoretical circumstance, the employee undoubtedly (and quite reasonably) expects a retirement benefit in the vicinity of $20,000 annually,[122] discounted for the year she quit early. However, if the plan is permitted to accrue benefits at the rate of one dollar per year until retirement, this employee is instead entitled to only twenty dollars annually, one dollar for each year worked. Only with the final year of participation would the employee have actually earned the benefit based on her final average salary.

One way of understanding this example is that the plan's hypothetical accrued benefit formula emasculates the vesting schedules promulgated in the Code and ERISA.[123] This theoretical employee has a fully nonforfeitable interest in the pension benefit

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[119] *See* I.R.C. § 411(b); *see also* ERISA § 204.

[120] *See supra* pp. 6-9.

[121] *See* I.R.C. § 411(b); *see also* ERISA § 204.

[122] Calculated as follows: 0.5 x $40,000 = $20,000.

[123] I.R.C. § 411(a); ERISA § 203. *See generally* LANGBEIN & WOLK, *supra* note 83, at 97; Peter M. van Zante, *Mandated Vesting: Suppression of Voluntary Retirement Benefits*, 75 NOTRE DAME L. REV. 125, 160-62 (1999).

she earned through age sixty-four. However, that interest is de minimis since the pattern of benefit accrual effectively postpones the participant's opportunity to earn her benefit until her last year of employment. To prevent this evisceration of the vesting rules, the Code and ERISA regulate the minimum pace at which defined benefit plans must permit participants to earn their benefits and thereby preclude excessive backloading.[124]

Critical to the application of the statutory accrued benefit rules to cash balance plans is the definition of a participant's accrued benefit. For defined benefit plans, a participant's accrued benefit must be calculated in terms of a traditional annuity starting at retirement.[125] Only defined contribution plans can state accrued benefits in terms of account balances.[126] Moreover, unlike the nondiscrimination context, there is no statutory or regulatory basis for "cross-testing" in the accrued benefit context.[127] Thus, determining the compliance of cash balance plans (defined benefit arrangements) with the accrued benefit requirements of the Code and ERISA requires the translation of each participant's hypothetical account balance into an annuity and the subsequent assessment whether or not the participant earns that annuity in accordance with the statutory requirements for accruing minimum benefits over time.

The translation of cash balance accounts into annuity equivalents typically indicates that the rate of benefit accrual

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[124] *See* I.R.C. § 411(b); *see also* ERISA § 204.

[125] *See* I.R.C. § 411(a)(7)(A)(i); *see also* ERISA § 3(23)(A).

[126] *See* I.R.C. § 411(a)(7)(A)(ii); *see also* ERISA § 3(23)(B).

[127] The apparent statutory basis for the cross-testing provisions of the nondiscrimination Regulations is the statutory mandate that qualified plans not favor highly compensated employees as to "contributions or benefits." *See* I.R.C. § 401(a)(4). This language does not explicitly link nondiscriminatory benefits to defined benefit plans or nondiscriminatory contributions to defined contribution plans. Therefore, the statute can plausibly be read as authorizing cross-testing, i.e., looking at the contributions under defined benefit plans and at the benefits yielded under defined contribution arrangements.

However, the Code and ERISA provide separate statutory schemes for measuring defined benefit and defined contribution accruals and thus leave no room for a cross-testing approach in the context of accruals. As a statutory matter, defined contribution plans determine accrued benefits in terms of account balances. Defined benefit plans determine accrued benefits in terms of annuities payable at retirement. Cash balance plans are defined benefit arrangements and thus must be tested as such, i.e., in annuity terms.

drops as the participant gets older.[128] This conclusion stems from the fact, previously-noted,[129] that the present values of annuities starting at normal retirement are less for younger participants since there are more years until their retirement and thus more years to the commencement of the annuity. The same arithmetic indicates that a stable amount contributed annually to a notional cash balance account yields progressively less in annuity terms as the participant gets older since there are fewer years for the contribution to accumulate investment interest.

Consider, for example, a participant who, at ages thirty-five, forty-five, and fifty-five, receives in each year a theoretical contribution of $1000 to her hypothetical cash balance account. As of age sixty-five, the earliest contribution will, in annuity terms, represent an annual income of $1094 per year;[130] the $1000 contributed ten years later at age forty-five will constitute at retirement an annuity of $507 per year;[131] and the last $1000 contributed at age fifty-five will, at retirement, represent an annuity of $235 per year.[132] Thus, even though the employee, in defined contribution terms, has been accruing contributions at a steady pace (i.e., $1000 per year), the employee has been earning benefits at a decreasing rate in defined benefit terms. Since later contributions have less time for investment growth, they generate less annuity income at retirement than earlier contributions, which have more time to grow from investment earnings.

In simple terms, cash balance plans generally[133] represent the opposite of the problem at which the accrued benefit rules are aimed. In annuity terms,[134] cash balance plans frontload rather

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[128] There are those who disagree with this assertion. Their analysis is discussed below. *See infra* pp. 57-63.

[129] *See supra* pp. 8-9.

[130] Calculated as follows: ($1000 x 1.08^30)/9.196 = $1094.

[131] Calculated as follows: ($1000 x 1.08^20)/9.196 = $507.

[132] Calculated as follows: ($1000 x 1.08^10)/9.196 = $235.

[133] The important exception is the possibility that a wear-away formula may violate the backloading rules for accrued benefits when the wear-away period ends and the accrual of benefits commences under the new cash balance plan. *See infra* note 223.

[134] This is an important qualification. In defined contribution terms, typical cash balance plans are neutral – neither frontloading nor backloading – since the percentage of salary credited to each employee's notional account is stable throughout the employee's working career, e.g., ten percent of each year's salary. However, when those contributions are translated into annuity equivalents, the result is often a continual decline in benefits

than backload.

C. Actuarial Assumptions and Lump Sums

Section 401(a)(25) requires defined benefit plans to specify their actuarial assumptions "in a way which precludes employer discretion." Thus, for example, if a traditional defined benefit plan furnishes the option of a lump sum distribution in lieu of an annuity, the interest rate used to convert annuities into lump sums must be predetermined. The employer cannot mandate a higher interest rate (and thus a lower lump sum) for a disfavored employee while selecting a lower interest rate (and thus a larger lump sum) for a better-liked colleague.

Under section 411(a)(11)(A) and ERISA section 203(e), the plan cannot force the participant to accept her benefit "immediately" if the present value of the participant's vested accrued benefit exceeds $5000. Section 417(e)(1) and ERISA section 205(g)(1) permit plans to make immediate lump sum distributions of annuity benefits if the present value of such benefits (and, hence, the lump sum to be distributed immediately) is $5000 or less. In contrast, section 417(e)(2) and ERISA section 205(g)(2) forbid distribution of a benefit otherwise payable as an annuity as an immediate lump sum without participant and spousal consent if the present value of such benefit is greater than $5000.

To explore how these provisions work, suppose that two vested participants in a defined benefit arrangement both leave employment at age forty-five. One participant has earned an annuity with a present value of $10,000, while the other participant has earned an annuity with a present value of $2000. To minimize future administrative expenses and bother, the employer wants to distribute a lump sum to both employees now rather than defer the payment of their respective benefits until normal retirement. Under the relevant statutes, the employer can require the participant with the smaller benefit to accept a $2000 payment immediately; however, the employer cannot require her

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accrued since stable contributions over time produce progressively smaller annuity amounts as the employee gets older.

colleague (with a benefit valued over $5000) to accept distribution of an immediate lump sum.[135] The employer must first obtain the consent of the participant and her spouse to make such payment now.[136]

Under section 417(e)(3) and ERISA section 205(g)(3), for purposes of determining whether the present value of a participant's vested benefit exceeds the $5000 threshold requiring participant consent for lump sum distribution, the plan must use a government-supplied interest rate and morality table, rather than the plan's own actuarial assumptions. In making this determination, the plan must generally[137] use an interest rate equal to the then-prevailing rate on Treasury debt with a thirty-year maturity as well as prescribed mortality tables.

While these statutes define a precise and limited role for the government-supplied actuarial assumptions – determining whether or not a distribution triggers the $5000 threshold for employee consent to immediate distribution – the Treasury Regulations[138] expansively interpret the function of these assumptions. According to the Regulations, these government-supplied mortality tables and interest rates must be used to calculate the actual amount distributable as a participant's lump sum in a defined benefit plan, not just to determine whether or not consent is required for a lump sum distribution.[139] In Notice 96-8,[140] the Internal Revenue Service (Service) amplifies this position

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[135] *See* I.R.C. §§ 411(a)(11)(A), 417(e); *see also* ERISA §§ 203(e), 205(g)(2).

[136] *See id.*

[137] During a transition period now coming to an end, some plans have instead used, for these purposes, an interest rate determined by the Pension Benefit Guaranty Corporation (PBGC). *See* I.R.C. § 417(e)(3)(B); *see also* ERISA § 205(g)(3)(B).

[138] *See* Treas. Reg. § 1.411(a)-11(d) ("In determining the present value of any distribution of any accrued benefit from a defined benefit plan, the plan must take into account specified valuation rules. For this purpose, the valuation rules are the same valuation rules for valuing distributions as set forth in section 417(e)."). Treas. Reg. § 1.417(e)-1(b)(2)(ii) similarly provides that defined benefit plans are limited by the government-supplied interest rate "[i]n determining the present value of *any* nonforfeitable accrued benefit." (emphasis added).

Likewise, Temp. Treas. Reg. § 1.417(e)-1T(d) requires the use of the section 417(e)(3) interest and mortality assumptions for determining "the present value of *any* accrued benefit." (emphasis added).

[139] *See* Treas. Reg. §§ 1.411(a)-11(d), 1.417(e)-1(b)(ii); *see also* Temp. Treas. Reg. § 1.417(e)-1T(d).

[140] 1996-1 C.B. 359.

in the cash balance context. The government's insistence that the statutory assumptions be used to calculate participants' actual lump sum distributions is particularly significant in the wear-away setting. As noted earlier,[141] the selection of a higher (or lower) interest rate for determining the lump sum value of an annuity accrued under a conventional defined benefit regime will result in a lower (or higher) calculation of that value and thus a shorter (or longer) wear-away period.

As discussed below,[142] the government's expansive view of the role of the statutory actuarial assumptions cannot be reconciled with the literal terms of the statutes which require use of the government-supplied factors only to measure a lump sum to assess the $5000 threshold for the requirement of participant consent, not to displace the actuarial assumptions specified by the plan per section 401(a)(25) when determining the actual amount of the distribution.

D. Prohibition on Age-Based Reductions of Accrual Rates

Section 411(b)(1)(H)(i), ERISA section 204(b)(1)(H)(i), and ADEA section 4(i)(1)(A)[143] provide for defined benefit plans that "the rate of an employee's benefit accrual" cannot be reduced because of the attainment of any age. Section 411(a)(7)(A)(i) and ERISA section 3(23)(A) provide that, for defined benefit plans, a participant's accrued benefit must be "expressed in the form of an annual benefit commencing at normal retirement age."[144] As discussed below,[145] these provisions provide strong statutory support for part of the critique of cash balance plans since participants' accrued benefits, expressed in annuity terms, typically decline as participants age.

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[141] *See supra* pp. 22-23.

[142] *See infra* Part V(B).

[143] Pub. L. No. 90-202, 81 Stat. 602, 603 (codified as amended at 29 U.S.C. § 623(i)(1)(A)).

[144] Section 411(c)(3) and ERISA section 204(c)(3) provide that, for any defined benefit plan which determines accrued benefits other than as standard annuities at normal retirement, such accrued benefits must be "the actuarial equivalent" of such annuities. The upshot, again, is to tie accrued benefits in the defined benefit context to annuities starting at normal retirement.

[145] *See infra* Part V(A).

E. Participant Notification of Reduced Rate of Benefit Accrual

ERISA section 204 requires, for all pension plans, that participants, beneficiaries, and any union representing participants receive "written notice" of any plan amendment which "provide(s) for a significant reduction in the rate of future benefit accrual."[146] Specifically, such an amendment cannot go into effect unless, after the amendment is enacted but at least fifteen days before such amendment is effective, participants, beneficiaries, and unions are furnished with notice "setting forth the plan amendment and its effective date."[147] As discussed below,[148] the adequacy of this notice provision has been a major issue in the cash balance controversy.

IV. CRITICS AND DEFENDERS

A. The Critique of Cash Balance Plans

In this section, the contentions advanced to date by the critics and proponents of cash balance plans are outlined. Virtually all criticism of cash balance arrangements has been aimed at the conversion of conventional defined benefit plans, rather than at the creation of cash balance plans *ab initio*.[149] The criticism of such conversions has largely advanced under the rubric of age discrimination. At its most basic, the age discrimination indictment of cash balance plans contends that such plans flunk the requirements of section 411(b)(1)(H)(i), ERISA section 204(b)(1)(H)(i), and ADEA section 4(i)(1)(A), since defined contribution-style allocations, when converted into annuity equivalents, purchase progressively less in annuity terms as participants age. These statutes provide, in the defined benefit

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[146] ERISA § 204(h)(1).

[147] *Id.*

[148] *See infra* pp. 49-50.

[149] *See, e.g.*, J. Mark Iwry, *Treasury Benefits Counsel's Testimony At Senate Hearing On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-10, ¶ 16) ("Most of the recent controversy relating to the use of cash balance pension plans has focused on conversions of traditional defined benefit plan structures into cash balance plans.").

context, that "the rate of an employee's benefit accrual" cannot be "reduced...because of the attainment of any age."[150] Cash balance plans are defined benefit plans. Hence, the argument goes, such plans violate the statutory prohibitions on age-based reductions in accrual rates since the employee's attainment of an older age decreases the annuity equivalent of that year's contribution relative to the annuity value of the same contribution in prior years.

Moreover, the rhetoric of some cash balance opponents suggests a broader indictment. Consider, in this context, the controversy surrounding IBM's conversion of its conventional final average pension to the cash balance motif.[151] A consistent refrain of those claiming age discrimination was that older IBM employees would, as a result of the conversion, amass less pension wealth than if they were permitted to stay with the traditional pension formula.[152] IBM's critics also urged that IBM had an obligation to use surplus pension assets to permit older employees to accumulate the retirement wealth they had been promised under

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[150] *See* I.R.C. § 411(b)(1)(H)(i); *see also* ERISA § 204(b)(1)(H)(i); ADEA § 4(i)(1)(A).

[151] *See, e.g.*, Sen. Patrick J. Leahy, *Leahy Testimony at Senate Pensions Committee Hearing on 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-16, ¶ 9) ("[W]hen a company converts to a cash-balance plan, workers in their 40s and 50s lose the opportunity to earn their pension based on their highest salary as they were promised."); Rep. Bernard Sanders, *Sanders's Remarks at Senate Pensions Committee Hearing on 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-17, ¶ 4) (IBM employees "have every right to expect" continuation of traditional final average salary pension); Bill Syverson, *IBM Engineer's Testimony At Senate Hearing On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-18, ¶ 14) (demanding that "ALL vested IBM employees" have the option of coverage under "the traditional pension plan similar to the one in effect prior to 1995.") (emphasis in original); Krueger, *supra* note 89, ¶ 15 ("In our opinion, the excess money in the pension fund should be divided between cost of living increases for current retirees and continued support of the old pension plan for IBM employees."); Colleen T. Congel & Elizabeth A. White, *Consensus on Cash Balance Conversions Unlikely; IBM Official Defends Actions*, 175 DAILY TAX REP. (BNA), Sept. 10, 1999, at G-5 (quoting IBM employee Evelyn Adams: "Let me be absolutely clear about what thousands of IBM employees are asking for – that the IBM Corp. use some of the $8 billion dollar pension surplus to keep promises that so many of us have worked long and hard for."); Karen W. Ferguson, *Pension Rights Center's Remarks At Hearing On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-23, ¶ 24) ("For employees, these expectations were based on what they thought was an explicit promise that as long as their pension funds had sufficient assets, they would receive the benefits expressly provided by the terms of their plans.").

[152] *See id.*

the conventional formula.[153] Such claims go beyond the realm of age-based accrual rates to suggest that employees have legitimate expectations both in the continuation of traditional pension formulas and in surplus pension assets.[154]

Such claims, pushed towards their logical conclusion, suggest that traditional pension formulas, once established, cannot be restricted in any way nor can final average plans be terminated since, in either event, older employees wind up with less pension wealth than if existing plans were unchanged. Indeed, pushed to their logical conclusion, these claims suggest that older employees are entitled to traditional defined benefit pension coverage, that defined contribution arrangements can never satisfy older workers since such arrangements, understood in annuity terms, inherently favor younger employees.

Yet another criticism of cash balance conversions traveling under the banner of age discrimination is the critique of wear-away methods.[155] Such methods, we have seen,[156] freeze the participant's previously-earned benefit under the traditional pension formula until the new cash balance approach catches up with that previously-earned benefit. Only when the cash balance calculation finally matches the benefit already accrued under the old formula does the participant's pension entitlement start to grow again under the new cash balance regime.[157]

At one level, wear-away formulas do not raise the issue of age discrimination as such, since such formulas, on their face, apply to all participants whose accrued benefits under the displaced

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[153] *See id.*

[154] On the general subject of participants' legal relationship to the assets of defined benefit plans, see generally Alvin D. Lurie, *The Themes And Variations of* Hughes Aircraft: *A New Sound For A New Millennium*, NYU PROC. 57TH INST. ON FED. TAX'N – EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION § 11.00 (Alvin Lurie ed. 1999).

[155] *See, e.g.*, Sen. James M. Jeffords, *Jeffords' Remarks At Senate Pensions Hearing On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999)(LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-13, ¶ 14) ("This is the so-called 'wear-away' of benefits. This is apparently authorized by Treasury Department regulations as a means to transition to a reduced benefit, but I think it should be prohibited."); Sen. Tom Harkin, *Harkin Testimony At Senate Hearing On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999)(LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-15, ¶ 10) (Wear-away is "age discrimination, since a new employee is receiving higher pay for the same work, when you factor in the money the employer puts into their pension plan.").

[156] *See supra* Part II(D)(3).

[157] *See id.*

conventional method exceed their entitlements under the new cash balance calculation. In practice, however, the employees affected by wear-away provisions will often[158] be older participants who have amassed relatively large benefits pursuant to traditional final average arrangements and thus, must undergo a fallow period during which the cash balance calculation catches up with those benefits.[159]

In addition to age discrimination, the second major theme of cash balance critics has been the alleged inadequacy of existing disclosure requirements.[160] As noted earlier, current law mandates that affected participants[161] be notified of those plan amendments which significantly reduce future benefit accruals.[162] As a matter of timing, such notification is furnished after any such amendment is already adopted and may be furnished as late as the fifteenth day prior to the effective date of such amendment.[163] Moreover, as a substantive matter, such notice need not provide participants with particularized information about the impact of the new amendment on them individually.[164]

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[158] But not always. For example, wear-away situations may also arise when a corporation with a more generous pension plan is merged into a corporation with a less bountiful arrangement. In that case, the benefits of the employees of the merged corporation will often be frozen until such employees' entitlements under the less generous plan of the surviving corporation catches up. *See* Robert G. Chambers, *APPWP'S Testimony At Senate On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-21, ¶ 12) ("[P]eriods without new accruals can result from constructive and necessary plan changes, such as updating plan mortality assumptions to provide more accurate benefits, aligning the benefits of employees from different companies in the wake of business acquisitions and mergers, or revising a plan to meet new statutory requirements.").

[159] As discussed *infra* pp. 57-63, the defenders of cash balance plans have not left these age-based criticisms unanswered. I conclude that, as a statutory matter, there is much validity to these criticisms but that, as a matter of policy, there is no reason, for age discrimination purposes, to treat cash balance plans differently from true defined contribution arrangements.

[160] *See, e.g.*, Jeffords, *supra* note 155, ¶ 10 ("Workers who have been notified of the change in their benefits believe the notice conceals from them the magnitude of their future benefit reductions. Few employees have such sophisticated financial skills that they can decipher their new benefit formula."); Harkin, *supra* note 155, ¶ 15 ("The very weak rules on disclosure about the real effects of plan changes is another area that needs legislative action."); Iwry, *supra* note 149, ¶ 35 ("The notice mandated by current law will not adequately answer the questions employees have about plan changes.").

[161] As well as beneficiaries and unions.

[162] *See supra* Part III(E).

[163] *Id.*

[164] *Id.*

A consistent theme of cash balance critics has been the inadequacy of these disclosure provisions and the need to mandate more timely and more detailed information for those affected by cash balance conversions.[165] In effect, the argument goes, current law mandates notices that can be late and can consist of little more than legalese that, in practical terms, does not inform the affected participants.[166]

B. The Defense of Cash Balance Plans

While the opponents of cash balance arrangements suggest that such arrangements are poorly understood by affected participants (who consequently need better disclosure),[167] proponents of cash balance plans advance essentially the opposite contention.[168] Such proponents contend that cash balance plans, because of their defined contribution/individual account motif, are better comprehended by today's workers.[169] In a world of IRAs and 401(k) plans – a defined contribution culture, if you will[170] – traditional annuity formulas are dinosaurs, poorly understood and not fully trusted by employees who think in terms of individual accounts.[171] To these proponents, it is not the cash balance

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[165] *See supra* note 160.

[166] *See id.*

[167] *See id.*

[168] *See* Jacobius, *supra* note 5, at 1 (quoting Sheila Forsberg, director of global retirement benefits strategy of Motorola, Inc., as saying that Motorola's new pension equity plan, a type of cash balance arrangement, "is much simpler to understand" than conventional defined benefit pensions). *See also* Jonathan Barry Forman, *Cash Balance Pension Plans*, J. REC. (Sept. 8, 1999), at 5 ("The typical young worker does not expect to stay with one company for his entire career, so he does not place much value on the traditional pension plan."); J. Thomas Bouchard, *IBM Human Resources' Testimony At Senate Hearing On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-20, ¶ 10) ("IBM's prior pension plan design was not as valued by our workforce [because] it was complex and difficult to understand."); John F. Woyke, *Towers Perrin Principal's Testimony At Senate Hearing on Pension Plans*, TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-26, ¶ 15) ("In addition to being more beneficial to mobile employees, cash balance plans are often found to be attractive because employees can understand their value.").

[169] *See id.*

[170] *See generally* Edward A. Zelinsky, *ERISA and the Emergence of the Defined Contribution Society*, NYU PROC. 57TH INST. ON FED. TAX'N – EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION § 6.01 (Alvin Lurie ed. 1999).

[171] *See supra* note 168.

conversion which is opaque but the traditional annuity formula which no longer corresponds to employees' understanding of pension wealth.

Intimately tied to the claim that cash balance plans, because of their notional account balances, are better comprehended by participants in a defined contribution culture is the claim that cash balance plans, because they emulate defined contribution arrangements, are better adapted to the contemporary work place, allegedly a place of great mobility and little long-term loyalty.[172] The traditional annuity formula, the argument goes, reflects an older, more stable workplace, a workplace in which employees frequently stayed with one or two employers for the length of their careers.[173] In such an environment, the traditional final average formula rewarded the expectation of both the employer and the employee that they would remain in a stable relationship until the employee's retirement, at which point the weekly pay check from the employer would be replaced by the monthly retirement check from the employer's pension plan.[174]

That world, the argument continues, no longer exists.[175] A defined contribution-style account balance, distributable as a lump sum to the employee at the end of what is generally a relatively short-term employment relationship, the argument goes, is better adapted to a world in which employee mobility is the norm.[176] In the parlance of the pension community, portability – the ability of employees to take their pension benefits with them when they change jobs – is the appropriate response to an economy in which frequent job changes are the rule, rather than the exception. A particularly interesting variant of this argument is that female employees, because of their relatively short job tenures, are prime beneficiaries of the switch from traditional final average salary

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[172] As observed, commentators disagree as to the reality *vel non* of the widespread perception that employee mobility has significantly increased in recent years. *See supra* note 79.

[173] *See* STEVEN A. SASS, THE PROMISE OF PRIVATE PENSIONS 240-46 (1997).

[174] *See id.* at 240.

[175] *See id.* at 240-46.

[176] *See* Bouchard, *supra* note 168, ¶ 9 ("[T]he traditional defined benefit model was offering relatively little value to those employees who were, realistically, not going to spend a full career with IBM."); *see also* Woyke, *supra* note 168, ¶ 10 ("Cash balance plans were developed in part to respond to the reality of a mobile workforce.").

pensions to cash balance arrangements and the greater portability of such arrangements.[177]

Moreover, defenders of cash balance plans note, employers, to adapt to an environment of greater worker mobility, can terminate existing defined benefit plans and switch to a true defined contribution format with account balances and lump sum distributions.[178] From this perspective, the critique of cash balance plans is particularly misguided since the age-based impact of any such plan is identical to terminating a traditional defined benefit plan and replacing it with a conventional defined contribution arrangement – something the employer can do in lieu of the cash balance conversion.[179]

However, the defense continues, cash balance plans (unlike true defined contribution arrangements) permit employers to remain within the defined benefit system, guaranteeing employees a specified benefit which the employer is obligated to finance.[180] The employee is thus better off with a cash balance conversion (since the employer continues to absorb investment risk and guarantee a specified benefit under a cash balance formula) than with the available alternative – termination of the defined benefit plan altogether and its replacement by a defined contribution arrangement, an arrangement which shifts the risks and benefits of investment performance to the employee.

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[177] *See* Chambers, *supra* note 158, ¶ 8 ("The percentage of women faring better under cash balance plans was even higher – about three-quarters – due to their tendency to have shorter job tenure.").

[178] *See, e.g.*, Bouchard, *supra* note 168, ¶ 19 ("Federal law...would have allowed IBM to terminate its pension plan, cease benefit accruals,...offering a 401(k) plan as the primary retirement savings tool.").

[179] *See* Forman, *supra* note 7, ¶ 3 ("A conversion from a traditional defined benefit plan to a cash balance plan looks a lot like a conversion from a defined benefit plan to a defined contribution plan.").

[180] *See, e.g.*, Bouchard, *supra* note 168, ¶ 19 ("Federal law, as you know, would have allowed IBM to terminate its pension plan, cease benefit accruals, . . . offering a 401(k) plan as the primary retirement savings tool. IBM chose not to do that. Instead, IBM decided to keep the company-funded pension plan."); Association of Private Pension and Welfare Plans, *APPWP Release Opposing Cash Balance Conversion Plan Legislation*, (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-32, ¶ 4) ("Cash balance and other hybrid defined benefit plans have been the one hopeful sign amid this ominous trend toward plan termination. They preserve the design and policy advantages of traditional plans while responding to current marketplace demands for features traditionally associated with 401(k) plans."). *See also* Congel, *supra* note 6, at J1.

V. SORTING THE SITUATION

In this section, analysis of the legal and policy issues raised by cash balance plans is provided. In a controversy of this sort, legal and policy considerations tend to merge. Nevertheless, for purposes of organization, it is helpful to address the more technically legal issues in the cash balance controversy first and then move to broader considerations of policy.

A. Prohibition on Age-Based Accrual Reductions

1. In General

Let us consider initially the statutory prohibitions on age-based reductions in the rate of benefit accruals and the legal implications of those prohibitions on cash balance plans. Those implications are necessarily fact-specific and plan-specific. It is theoretically possible to design a cash balance formula which satisfies the age-discrimination tests for defined benefit arrangements. Nevertheless, I conclude that most cash balance plans, as they exist today, violate the literal terms of section 411(b)(1)(H), ERISA section 204(b)(1)(H), and ADEA section 4(i)(1)(A).

There is no dispute about the underlying arithmetic of cash balance arrangements: each year, as a cash balance participant ages, the same contribution made for her in the previous year declines in value in annuity terms.[181] Moreover, cash balance arrangements are defined benefit plans and, therefore, measure accrued benefits in terms of annuities, not in terms of the contributions themselves.[182]

Consistent, age-based declines in the annuities earned by cash balance participants cannot be reconciled with the statutory mandate that, in the defined benefit context, "the rate of an employee's benefit accrual" not be "reduced because of the

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[181] *See supra* p. 42.

[182] As noted above, there is no statutory basis for cross-testing in the context of measuring the accrual of benefits. *See supra* note 127.

attainment of any age."[183] When a thirty-five year-old cash balance participant earns a deferred annuity benefit of $1094 per year from a current contribution of $1000, a forty-five year-old participant accrues a deferred annuity benefit of only $507 annually from that same $1000 contribution, and a fifty-five year-old participant earns an annuity of $235 from a $1000 contribution to her notional cash balance account,[184] the rate of benefit accrual measured in annuity terms is declining with age. As Lee Sheppard notes:

> If rate of accrual is defined by projecting the participant's benefit to an annual benefit beginning at normal retirement age, then cash balance plans flunk, because the size of a participant's actuarially determined benefit is purely a function of his or her age. Indeed, it is impossible to estimate a cash balance plan participant's pension benefit without knowing his or her age.[185]

In theory, cash balance formulas, by each year increasing pay credit contributions, can maintain a level rate of benefit accrual in annuity terms as employees get older and can thus neutralize the effect of age on the rate of accrual. Suppose, for example, that a cash balance plan credits 20% of salary for participants age thirty-five, 21.6% of salary for participants age thirty-six, and comparably increasing percentages each year as participants continue to get older. Assume further that this plan covers one thirty-five year-old employee and one participant a year older, both of whom earn $20,000. In pay credit terms, the thirty-six year-old employee receives a larger contribution ($4320)[186] than the thirty-

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[183] *See* I.R.C. § 411(b)(1)(H); *see also* ERISA § 204(b)(1)(H); ADEA § 4(i)(1)(A).

[184] These numbers are developed *supra* p. 42.

[185] Lee Sheppard, *The Down-Aging of Pension Plans*, TAX NOTES TODAY (Jan. 11, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 6-6). My analysis is not precisely the same as Ms. Sheppard's since she perceives some room for interpreting the term "rate of an employee's benefit accrual." As I note in the text, I conclude that the meaning of this phrase is straightforward in the defined benefit context and, as applied to cash balance plans, refers to the measure of the participant's annual benefit increases, expressed in annuity terms at retirement.

[186] Calculated as follows: $20,000 x 0.216 = $4320.

five year-old ($4000).[187] In annuity terms, however, they each accrue in this year the same benefit ($4377 per year starting at age sixty-five) since the additional contribution for the older employee just balances the impact of her being one year closer to retirement.[188]

I doubt that there are many (perhaps any) cash balance plans which actually use annually increasing formulas of this type,[189] although some pension equity plans may prove similar in design. I am, moreover, skeptical that formulas which annually increase contributions with age will prove attractive to the sponsors of cash balance plans. A cash balance plan which increases contribution percentages yearly as employees' age falls outside the regulatory safe harbor for nondiscrimination as to highly compensated employees, a safe harbor which requires that participants receive the same dollar contribution or a contribution which is the same percentage of each participant's compensation.[190] Moreover, to the extent that employers prefer cash balance plans on the grounds that such plans are more attractive to younger employees (or less desirable to older workers), annually increasing contribution percentages for older employees go in the opposite direction.

Nevertheless, the possibility that a cash balance plan, via annually increasing pay credit percentages, might be crafted to satisfy the defined benefit age discrimination test highlights the fact-specific and plan-specific nature of the age discrimination inquiry. This possibility also highlights the failure of most existing cash balance plans to neutralize the effect of age in this (or

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[187] Calculated as follows: $20,000 x 0.2 = $4000.

[188] As to the 35 year-old, her $4000 contribution will in 30 years grow to a lump sum of $40,251, a lump sum which purchases an annuity of $4377 starting at age 65. As to the 36 year-old, her larger contribution of $4320 will grow for 29 years, i.e., one year less, and will constitute, at age 65, the same lump sum balance ($40,251) which purchases the same annuity ($4377 yearly).

[189] Some cash balance plans do increase contribution rates for cohorts, e.g., three percent of salary for all employees in their thirties, four percent of salary for all employees in their forties, etc. *See* Ron Gebhardtsbauer, *Actuaries' Remarks At Senate Hearing On 'Hybrid Pension Plans,'* TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-22). However, these plans do not comply with the statutory prohibition on age-based reductions in benefit accruals since, within each cohort (receiving the same pay credit contribution), the annuity value of that contribution declines each year as the participant ages.

[190] *See* Treas. Reg. § 1.401(a)(4)-8(c)(3)(iii)(B).

another) fashion and thus confirms the literal noncompliance of most cash balance arrangements with the current statutory prohibitions on age discrimination in the defined benefit setting, prohibitions which test for age discrimination in annuity terms.

A principal[191] argument for avoiding the literal import of sections 411(b)(1)(H), ERISA section 204(b)(1)(H), and ADEA section 4(i)(1)(A) invokes the Proposed Regulations under section 411(b)(1)(H). These Regulations indicate that a mere "positive correlation" between age and reduced benefit accruals does not violate the statutory prohibition on age-based benefit accrual reductions.[192] Cash balance plans merely entail such correlation, the argument goes, and thus do not violate the statutory prohibitions on age-based reductions in accrual rates.

The simple rejoinder is that this defense relies, not on the language of the relevant statutes, but only on Regulations – and Proposed Regulations at that. Moreover, a thorough reading of the relevant Regulations indicates that the "positive correlation" test does not protect most cash balance plans from the charge of age discrimination.

As an example of permitted positive correlation between age and benefit accrual reductions, the Proposed Regulations discuss a plan in which correlation exists between "increased age and completion of the specified number of years of credited service."[193] The Proposed Regulations explicitly condone a formula under

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[191] Attorney Lawrence Z. Lorber argues that cash balance plans do not violate ADEA section 4(i)(1)(A), principally because a majority of the Courts of Appeal have rejected the doctrine of disparate impact in the context of age discrimination. *See* Morton Bahr, *Employment Lawyer's Remarks At Senate Hearing On Pension Plans*, TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-25). A similar argument is advanced by Attorney Michael S. Horne. *See* Michael S. Horne, *ERISA Industry Committee Report On Legality Of Cash Balance Plans*, TAX NOTES TODAY (Sept. 22, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 183-33).

However, Mr. Lorber does not confront the literal terminology of section 411(b)(1)(H), ERISA section 204(b)(1)(H), and ADEA section 4(i)(1)(A). Under these quite specific provisions, the relevant issue is not the Supreme Court's ultimate decision concerning the applicability *vel non* of disparate impact theory generally. The relevant inquiry is more targeted and asks whether these particular statutes are violated by the design of cash balance plans. And, in answer to that inquiry, most cash balance plans do reduce "the rate of an employee's benefit accrual ... because of the attainment of any age" since such accruals must be measured in annuity terms and contributions purchase less annuity income as participants get older. I.R.C. § 411(b)(1)(H)(i).

[192] Prop. Treas. Reg. § 1.411(b)-2(a).

[193] *Id.*

which a participant earns an annuity benefit of two percent of compensation for each of her first fifteen years of service but only one percent of compensation for years sixteen and later.[194] Such a formula is permitted even though the employees with sixteen or more years of service (who accrue less annually) will tend to be older than the employees with fifteen or fewer years of service (who earn more pension benefits as a percentage of income for each year worked). However, immediately after this hypothetical, the Proposed Regulations caution that the permitted reduction in accrual rates from two percent annually to one percent per year "may not be based, directly or indirectly, on the attainment of any age."[195]

The problem for typical cash balance plans is that the reduction in participants' accrual rates measured in annuity terms is indeed based on the attainment of age since it is age, not service, which results in a progressive decline of the annuity value of cash balance contributions every year. Whether, in the context of cash balance arrangements, one characterizes the effect of age as direct or indirect, that effect is inherent in the translation of contributions to annuity equivalents and is thus integral to the design of most cash balance plans, not a matter of mere "correlation."

In sum, even if the Proposed Regulations are finalized in their current form and are accepted as a definitive construction of the statutory prohibition on age-based benefit accrual reductions, those Regulations do not dismiss as a mere "positive correlation," the age-based benefit accrual patterns of cash balance plans. Rather, in the cash balance context, given roughly similar contributions to employees' notional accounts, age reduces benefit accruals in annuity terms which reduction is "based, directly or indirectly, on the attainment of any age."[196]

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[194] Prop. Treas. Reg. § 1.411(b)-(2)(b)(3)(i).

[195] Prop. Treas. Reg. § 1.411(b)-(2)(b)(3)(ii). As further amplification of the direct or indirect standard, the regulations also indicate that a termination or reduction of benefit accruals "for all plan participants" does not violate the statutory prohibition on age-based accrual reductions. *See* Prop. Treas. Reg. § 1.411(b)-(2)(a).

[196] There has been intense controversy among the mavens on this issue concerning comments in the preamble to the Regulations. Those comments indicate that typical cash balance formulas do not violate section 411(b)(1)(H) and its prohibition on age-based benefit accrual reductions. *See, e.g.*, Horne, *supra* note 191. I have trouble understanding how

A second argument advanced by cash balance defenders is that, in determining the annuity equivalent of any year's contribution, it is wrong to assume (as I and others have done) that interest necessarily accrues on that contribution to normal retirement.[197] This assumption, it is argued, improperly "frontloads" interest credits and thus overstates the annuity equivalent of the current contribution.[198] Instead, interest credits should be deemed to arise only with the passage of time and should be allocated to later years.

If, for example, a thirty-five year-old cash balance participant is granted a theoretical pay credit contribution of $1000 in year 2000, the corresponding annuity of that contribution, the argument goes, is not the annuity purchasable in year 2030 assuming that interest accrues on the $1000 until then. Rather, the annuity equivalent in year 2000 of the $1000 theoretically contributed in year 2000 is the annuity which $1000 (having sat fallow for thirty years without interest) will purchase in year 2030.

In the next year, 2001, the participant's benefit accrued in annuity terms for that year will be the annuity obtained with the year 2001 pay credit (without considering the next twenty-nine years of interest on that amount) plus the annuity purchasable with the year 2001 interest credit on the year 2000 contribution of $1000. In year 2002, the process continues with the participant earning increasingly large accrued benefits as she gets older since, in any year, the benefit accrued for that year includes both that particular year's pay credit in annuity terms plus the annuity equivalent of that year's interest on the cumulative total to date of all previous pay and interest credits. That cumulative total increases with each passing year and thus the annual accrued benefit under this approach also increases annually as the

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Regulations can override statutory language; I am even more skeptical that the preamble to Regulations can overcome the statute. I say this as one who believes that, as a matter of policy, these preamble comments are normatively correct: cash balance plans should, for benefit accrual purposes, be treated the same as defined contribution plans. However, I do not see how that result can be achieved without amending or ignoring the language of section 411(b)(1)(H), ERISA section 204(b)(1)(H), and ADEA section 4(i)(1)(A).

[197] *See* Horne, *supra* note 191, ¶ 10.

[198] *See id.*

participant ages.[199]

There are two problems with this theory, starting with the language of the statute which specifies, in the defined benefit context, that the participant's accrued benefit is "expressed in the form of an annual benefit commencing at normal retirement age."[200] It is an unnatural reading of that language to treat the annual benefit commencing at retirement as the benefit purchased by the current year's pay credit lying fallow until retirement. The more natural reading of the statutes is that the current year's pay credit is the discounted present value of an annuity starting at retirement and that the value of that annuity is determined by projecting interest compounded at the plan's discount rate.

Consider in this context a single premium deferred annuity policy. In the parlance of the insurance and employee plan communities, the premium is roughly the discounted present value of the policy's projected annuity, and the annuity under the policy is the amount of annual income which will be obtained when the contract matures.[201] It would be artificial to look at matters differently in the cash balance context.

Consider, moreover, the implications for traditional final average pensions arising from ignoring anticipated interest in the calculation of accrued benefits. There has, to date, been no ambiguity in the calculation of participants' accrued benefits under traditional plans. If, for example, a conventional pension promises a benefit of fifty percent of the final average salary multiplied by the years of service fraction (years of service to date over 30), a thirty-five year-old participant who works one year for compensation of $60,000 has an accrued benefit of $1000,[202] that is, the participant has earned, to date, $1000 of annual income

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[199] *See* Mark J. Ugoretz, *Debate On Cash Balance Plans Continues*, TAX NOTES TODAY (July 19, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 137-103, ¶ 15) ("If the interest were treated as accruing annually on the sum of all pay credits and interest credits in prior years, the annual interest credit would continually mount, and in the employee's last few years before normal retirement age, the interest credit would typically exceed by many fold the combined pay and interest credits awarded to younger employees who are in their early years of plan participation.").

[200] I.R.C. § 411(a)(7)(A)(i); ERISA § 3(23)(A).

[201] The premium also includes an amount for sales commissions and other administrative charges. *See* MCGILL ET AL., *supra* note 21, at 706.

[202] Calculated as follows: $60,000 x 50% x 1/30 = $1000.

starting at retirement.

However, under the alternative interpretation of the statute advanced by some cash balance proponents, this settled understanding of the term "accrued benefit" is wrong since, in the current year, we must ignore the interest anticipated over the next three decades. Applying this approach to traditional as well as cash balance pensions, the employee's accrued benefit would be determined by (1) calculating the discounted present value of a $1000 annuity starting at retirement (which present value is the analogue of the cash balance pay credit); (2) projecting that present value forward without interest to retirement age (the analogue of ignoring anticipated cash balance interest credits until later years); and (3) determining the annuity which can be purchased by this interest-less amount at retirement. Thus, it turns out that, contrary to common belief, the employee in a traditional pension plan has currently accrued benefits of only $99 per year,[203] that is, the annuity value of the year's contribution carried forward without interest to normal retirement age. Needless to say, this conclusion is at variance with the common understanding.

Moreover, even if the language of the statutes could be squared with the proposal to ignore currently anticipated interest credits in calculating cash balance accrued benefits, acceptance of that alternative interpretation of the statute would prove a pyrrhic victory for cash balance proponents since the progressively larger backloading of accrued benefits under this approach would generally violate the statutory prohibitions on such backloading.[204] In this respect, Notice 96-8[205] is correct when it opines that the backloaded theory of cash balance accruals, which ignores currently anticipated interest credits, flunks the general benefit accrual requirements of section 411(b) and ERISA section 204. This is not a happy outcome for cash balance proponents.

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[203] The underlying calculation is as follows: (1) $1000 of annuity income will be worth $9196 at age 65 ($1000 x 9.196 = $9196); (2) in the current year, 30 years before age 65, $9196 has a discounted present value of $914 ($9196/(1.08)^30 = $914); (3) $914 carried forward for 30 years without its anticipated interest purchases annuity income at age 65 of $99 per year ($914/9.196 = $99).

[204] *See* I.R.C. § 411(b); *see also* ERISA § 204.

[205] 1996-1 C.B. 359.

To refute the argument that cash balance plans violate the statutory prohibitions against age discrimination in accruing benefits, some cash balance defenders contend that a critical statutory term – "the rate of an employee's benefit accrual" – is undefined.[206] The apparent implication is that the resulting uncertainty makes the statute unworkable or, at least, subject to significantly different interpretations.

I am not convinced. Indeed, placing this terminology in context, it seems logical that it is not defined as such since the meaning of the phrase "the rate of an employee's benefit accrual" is not problematic. The relevant statutes define an employee's accrued benefit in a defined benefit setting as the annuity starting at normal retirement which the participant has earned under the terms of the plan.[207] Measuring the incremental annual change in that accrued benefit for an employee is not an overly complicated task. Finally, it is an equally surmountable task to assess the direction and magnitude of that change for the employee. In short, the statutes' age discrimination provisions do not suffer from any fatal indeterminacy. Indeed, for those who make their living parsing the texts of the Code and ERISA, "the rate of an employee's benefit accrual" is not the most problematic of statutory phrases.

A final argument is that cash balance plans should test for age discrimination, like defined contribution plans do, on the basis of current contributions rather than projected annuities.[208] As a matter of policy, I agree. However, as an issue of statutory construction, I cannot for several reasons. Cash balance plans, while they mimic defined contribution arrangements, are defined benefit pensions. According to the statutes, defined benefit plans test for age discrimination on the basis of projected annuities, not current contributions. Despite the logic in this context of cross-testing – letting cash balance plans assess age discrimination on a contribution basis – there is no warrant in the statutes for such cross-testing as the statutes explicitly distinguish between the

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[206] *See, e.g.*, Mark J. Ugoretz, *Sheppard's Attacks on Cash Balance Plans: A Response*, 84 TAX NOTES (TA) 465, 466 (July 19, 1999) (noting that "Sheppard acknowledges that 'the rate of an employee's benefit accrual' is not statutorily defined").

[207] *See* I.R.C. § 411(a)(7)(A)(i); *see also* ERISA § 3(23)(A).

[208] *See* I.R.C. § 411(b)(2)(A); *see also* ERISA § 204(b)(2)(A).

account balance-based age discrimination test for defined contribution plans and the annuity-based rate of accrual test for age discrimination in the defined benefit context. There is, in short, not enough flexibility in the statutory language to treat, for age discrimination purposes, cash balance plans as though they were defined contribution arrangements. Cash balance plans, it must be reiterated, are defined benefit arrangements.

As a matter of policy, I view it as an unfortunate conclusion that typical cash balance plans violate the strictures of section 411(b)(1)(H), ERISA section 204(b)(1)(H), and ADEA section 4(i)(1)(A), another instance of the over-regulation of defined benefit plans.[209] However, the statutes say what they say.[210]

This analysis under section 411(b)(1)(H), ERISA section 204(b)(1)(H), and ADEA section 4(i)(1)(A) undercuts the mantra of cash balance critics that the problem is the conversion of existing defined benefit plans to the cash balance format, rather than the creation of cash balance plans from scratch. The age discrimination problem under these statutory provisions is the same whether an existing plan switches to the cash balance format

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[209] *See generally* Edward A. Zelinsky, *Tax Policy v. Revenue Policy: Qualified Plans, Tax Expenditures, and the Flat, Plan Level Tax*, 13 VA. TAX REV. 591 (1994).

[210] Attorney Michael S. Horne, representing the ERISA Industry Committee, argues that Congress could not have intended to declare typical cash balance plans illegal when it legislated against age-based reductions in benefit accruals. Horne argues that it is anomalous to treat true defined contribution plans as acceptable in age discrimination terms while declaring the cash balance arrangements mimicking such individual account plans to be illegal. *See* Horne, *supra* note 191, at 10 (stating "[t]hat Congress had any such intention [to outlaw typical cash balance formulas] seems improbable").

Attorney Alvin D. Lurie is similarly critical of the analysis advanced in the text as are, apparently, Professor Jonathan Barry Forman and Ms. Amy Nixon. *See* Alvin D. Lurie, *Cash Balance Plans: Enigma Variations*, 85 TAX NOTES (TA) 503, 506 (Oct. 25, 1999) (stating "[t]he argument is very technical, but it is no more technical than it is specious"); *see also* Jonathan Barry Forman & Amy Nixon, *Cash Balance Pension Plan Conversions*, ___ OKLAHOMA CITY UNIV. LAW REV. ___ (forthcoming) (stating "it appears that the normal operations of a cash balance plan should not run afoul of the prohibition on age discrimination").

As I discuss below, I agree that the outcome compelled by the statutory prohibitions on age-based accrual reductions, that is, outlawing most cash balance formulas, makes little sense as a matter of policy and urge amendment of the statute. I am, however, skeptical of appeals to legislative intent and policy considerations when statutory language is directly on point. *See generally* Edward A. Zelinsky, Albertson's*: Why Courts Shouldn't Override Clear Statutory Language*, 66 TAX NOTES (TA) 1691 (Mar. 13, 1995); Edward A. Zelinsky, *Text, Purpose, Capacity and* Albertson's*: A Response to Professor Geier*, 2 FLA. TAX REV. 717 (1996).

or a cash balance plan is started anew. Either way, the rate of cash balance benefit accrual, measured in annuity terms, typically decreases with age in literal violation of the statutes.

2. Wear-Away Formulas.

My conclusions in the wear-away context are similar. While the ultimate inquiry is fact- and plan-specific, most wear-away formulas implementing cash balance conversions violate the statutory prohibitions on age-based reductions in benefit accrual rates. However, as a matter of policy, I am again skeptical that the result compelled by the statutes is correct.

Consider a two person final average plan with a thirty-five year-old employee and a fifty-five year-old employee. Suppose further that both employees have earned an annual salary of $150,000 for each of the last three years and that both have been employed for just these three years. In sum, the only variable which distinguishes these two employees for pension purposes is age.

Using our standard final average formula,[211] each has accrued an annuity at normal retirement of $7500.[212] The amount the plan will need for each at normal retirement is the same.[213] However, in present value terms, the older employee's accrued benefit of $31,946[214] is, because of her proximity to retirement, substantially larger than the lump sum accrued benefit of her younger colleague ($6854).[215]

Suppose now that the employer switches to a cash balance method with a wear-away provision. Assume in particular that, for each employee, the plan will determine her notional account balance retroactively to her first day of employment Each employee's pension entitlement will then be the larger of the present value of her accrued benefit under the prior plan or her cash balance account calculated back to the beginning of her

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[211] Fifty percent of final average pay times the years of service fraction (years of actual service divided by 30).

[212] Calculated as follows: $150,000 x 50% x 3/30 = $7500.

[213] Calculated as follows: $7500 x 9.196 = $68,970.

[214] Calculated as follows: $68,970/(1.08)^10 = $31,946.

[215] Calculated as follows: $68,970/(1.08)^30 = $6854.

employment and forward to the present. Let us further assume that this new cash balance plan has an annual pay credit of three percent of salary and a yearly interest credit of five percent.

Since our two employees are alike in all respects except age, they have the same retroactive account balance of $14,896[216] for their first three years of employment. On these assumptions, the wear-away provision does not impact the younger employee since her retroactively determined account balance of $14,896 exceeds her previously earned pension benefit expressed as a lump sum of $6854. She will thus receive a larger benefit under the new cash balance plan and will start to augment her pension wealth in her fourth year of employment (the first year of actual operation of the cash balance plan) as her notional account balance grows with the addition of that year's pay and interest credits. In contrast, the older employee's pension entitlement, expressed as a lump sum, remains frozen at $31,946 since this amount exceeds the cash balance account of $14,896 calculated retrospectively for her first three years of employment.

In year four, assuming that each employee's salary remains at $150,000 per year, each employee's respective notional account balance increases to $20,365, reflecting the retroactively calculated account balance plus one more year of pay and interest credits. For the younger employee, this fourth year of employment, the first under the new cash balance plan, entails bona fide growth to her pension wealth as witnessed by the increase in her account balance at the end of the fourth year. However, for the older employee, the increased theoretical account balance at the end of year four has no economic significance since her pension, as a lump sum, remains frozen at $31,946, the higher amount earned under the now-replaced final average formula. In effect, the older employee accrues no additional pension benefits in her fourth year of employment since her benefit remains fixed at the higher level earned previously under the old final average formula. Indeed, for the older employee in this example, the hypothetical cash balance account does not overtake her benefit earned under the prior

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[216] This is the amount which results from crediting each employee's notional account retroactively with three percent of salary (3% x $150,000 = $4500) and cumulatively crediting each account with interest at five percent per annum.

pension formula until year six when her notional account under the cash balance method reaches $32,139.[217] Even then, the older employee's pension accrual in her sixth year of employment (the third year of the cash balance method) is nominal, in lump sum terms a mere $193.[218]

From a statutory perspective, the question is: on these facts, has "the rate" of the older employee's "benefit accrual" been "reduced, because of the attainment of any age?"[219] I conclude that it has. The older employee had been accruing benefits at a healthy clip under the conventional formula. As a result of the conversion from that formula to a cash balance method with a wear-away provision, the older employee's accrual rate for years four and five drops to zero since, in those years, her effective pension stays flat as a result of the wear-away provision. Even in year six, the increase of the older employee's accrued benefit is nominal in contrast to the significant annual accruals she had experienced under the three years of final average coverage.

The statutory inquiry then becomes whether the decrease in the employee's accrual rate in her fourth, fifth and sixth years of employment was "because of the attainment of any age." The most natural reading of this language answers this question in the affirmative. In this example, the older employee, in comparison with her identical but younger co-worker, experiences a decrease in the rate of her pension accrual only because of her age, the sole variable which distinguishes the older from the younger worker.

Indeed, the impact of age becomes even clearer if we postulate a third employee with the same salary history as the other two but who has attained the age of sixty. This employee, since she earned the same compensation for her three years of employment, has the identical retroactively created account balance on the inauguration of the cash balance method ($14,896) but, in lump sum terms, has

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[217] For simplicity, I have assumed that both employees continue to earn $150,000 annually.

[218] This is the difference between the frozen present value of the benefit the older employee earned under the traditional formula ($31,946) and the value of her notional account balance in year six ($32,139) when that value finally exceeds (i.e., wears away) the present value earned under the conventional pension method.

[219] *See* I.R.C. § 411(b)(1)(H)(i); *see also* ERISA § 204(b)(H)(i); ADEA § 4(i)(1)(A).

a larger accrued benefit from the traditional plan ($46,940)[220] than her fifty-five year-old colleague. Consequently, the sixty year-old has a longer wear-away period during which she accrues no net pension benefit because her notional account balance is catching up to her previously accrued benefit under the final average approach. Only because the sixty year-old is older than her two co-workers does she have a longer wear-away period during which her rate of new benefit accrual is zero as her cash balance account catches up to her previously accrued benefit.

If we alter these examples by assuming that the employees' opening notional accounts will all start at zero (rather than the $14,896 from retrospectively determining account balances), the specifics change but not the substance. The younger employee now has a short wear-away period since her cash balance entitlement starts from scratch and thus takes a little time to catch up with her previously accrued benefit from the traditional formula. The younger employee's older co-workers now have even longer wear-away periods before their opening account balances (initially $0) reach and exceed their benefits earned under the old plan. Under this version of the cash balance method, the young employee again begins accruing benefits sooner since her account balance catches up with her previously earned benefit earlier. The older employees begin to accrue benefits later since their respective notional account balances take longer to reach the benefit level previously accrued under the final average method. Age is the variable which explains this difference.

The most obvious rejoinder is that, on conversion to the cash balance method, older employees experience a drop in their pension accrual rates, not because of age, but because their previously earned pensions, reduced to lump sum values, are larger. These larger, previously-earned pensions make for longer wear-away periods during which the cash balance formula must reach these previously earned levels. The problem with this rejoinder is that the older employees' accrued benefits under the conventional formula have higher lump sum values only because the older employees are older. In annuity terms, all of these

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[220] Calculated as follows: $68,970/(1.08)^5 = $46,940.

hypothetical employees have earned the same pension benefit at every stage of the traditional formula. It is only because the older employees are older, and thus closer to retirement, that their respective annuities translate into higher lump sums which effectively freeze (or freeze for longer periods) their pension entitlements during the first years of the cash balance conversion.[221]

Again, given the fact-specific nature of particular plans and their participants, these examples can be altered to make the situation more complex, more subtle, or both. However, many, if not most, cash balance conversions with wear-away features will impact older employees[222] in a fashion which runs afoul of the statutory prohibition on age-based decreases in the rate of defined benefit accruals.

As a matter of policy, I am troubled by this result and am skeptical that we should declare cash balance conversions with wear-away formulas to be age discriminatory. From one perspective, the older employee (rather than a victim of something bad) is better off than her younger co-worker since the older employee's pre-conversion pension entitlement, as a lump sum, is greater than the lump sum value of her younger co-worker's pension under the old plan. Nevertheless, the statutory test for age discrimination in the defined benefit context does not consider the greater lump sum value of the older worker's initial pension

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[221] Note that I am discussing wear-away formulas in the context of cash balance conversions. The analysis is different when a final average plan incorporates a wear-away provision. Suppose, for example, that a corporation with a more generous traditional plan is acquired by a firm with a traditional, but less remunerative, pension arrangement. Suppose further that the employees of the acquired firm are brought within the acquiring firm's plan subject to a wear-away clause, i.e., an acquired employee's pension benefit is the greater of her benefit under the old plan or under the (less generous) new plan of the acquirer. In that case, the acquired employees would, in their initial years with the new plan, not accrue additional benefits but would instead remain frozen at the higher pension levels earned previously under the more lucrative plan of the now-acquired firm. In this case, the relevant variable is not the employee's age. Rather, it is the more generous nature of the prior pension plan which results in an extended wear-away period.

[222] Indeed, in many cases, the conversion to a cash balance method will run afoul of the defined benefit age discrimination rules even without wear-away since the traditional annuity the older employee earns before the conversion will exceed the annuity the employee earns after the conversion under the cash balance formula. Hence, on the conversion, there is an age-based reduction in the rate of benefit accrual even without a wear-away formula reducing the new accrual rate all the way to zero.

benefit as a boon to her. Rather, the statutes merely look to the rate of future benefit accrual going forward from the point that the plan converts from the final average formula to the cash balance method. As to this post-conversion rate of benefit accrual, wear-away formulas generally have an age-based impact in the context of cash balance conversions by reducing to zero the older employee's accrual of pension benefits during the wear-away period and by elongating that period because of age.

In sum, I cannot reconcile my policy judgment that wear-away periods should be permitted with the constraints imposed by a reasonable respect for the statutory language defining age discrimination in the defined benefit context as a reduction of future accrual rates because of age.[223]

B. Notice 96-8, Lump Sums, and Government-Supplied Actuarial Assumptions

Just as a principled reading of section 411(b)(1)(H), ERISA section 204(b)(1)(H), and ADEA section 4(i)(1)(A) indicates that

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[223] Similar issues arise in the context of cash balance plans which use wear-away formulas and which purport to satisfy the Code and ERISA accrued benefit provisions by compliance with the "133 1/3 percent rule." *See* I.R.C. § 411(b)(1)(B); *see also* ERISA § 204(b)(1)(B). Under that rule, compliance is measured by determining the annual accrual rate for the current year (referred to in the statute as the "particular plan year"), by assessing the annual accrual rate for each future year (i.e. the "later plan year"), and by determining the accrual rates for the years between the current year and each future year. The plan satisfies the rule if the accrual rate for each later plan year is no more than 133 1/3 % of the accrual rate for the current plan year and for each year between the current year and the later year. *See id.*

In a wear-away context such as that discussed in the text, employees affected by the wear-away earn no pension benefits during the wear-away period, but resume the accrual of benefits after the wear-away period expires. Thus, the later, post-wear-away years have positive accrual rates while the earlier wear-away years have zero accrual rates. Hence, the accrual rate of the later years exceeds the zero rate of the wear-away years by an infinite percentage in violation of the rule that the later years' accrual rate exceed the earlier years' accrual rate by no more than 133 1/3 %. *See id.*

A cash balance plan with a wear-away formula may instead try to comply with the other two accrued benefit tests under the statutes. *See* I.R.C. § 411(b)(1)(A); ERISA § 204(b)(1)(A) (discussing the three percent method); *see also* I.R.C. § 411(b)(1)(C); ERISA § 204(b)(1)(C) (the fractional rule). The application of the 133 1/3 % rule in the cash balance context is now the subject of litigation in the Tax Court. *See IRS Agrees with Plan Participants: Amended Plan Was Disqualified*, TAX NOTES TODAY (LEXIS, FEDTAX lib., TNT file, elec. cit. 1999 TNT 166-10) (Aug. 27, 1999) (reprint of the Service's answer in *Arndt v. Commissioner*, Docket No. 33-99R).

typical cash balance benefit accrual rates impermissibly decline because of age, a searching reading of the relevant Code and ERISA provisions indicates that the Regulations and Notice 96-8[224] overstate the government's authority when they mandate the use of the government-supplied interest rates and mortality tables to determine lump sum payments to cash balance participants. The applicable statutes prescribe a limited role for these rates and tables. They are to be used "for purposes of"[225] determining whether or not the present value of a participant's annuity is above or below the $5000 threshold for immediate distribution with (or without) employee consent.[226]

Once it has been determined that a benefit falls above or below that threshold, the actual amount of the benefit to be distributed is not calculated with the interest and mortality assumptions of section 417(e)(3) and ERISA section 205(g)(3). Rather, at that point, the plan's stated actuarial assumptions, per section 401(a)(25), control the determination of the amount of the benefit actually to be paid.[227] There is no warrant in the statute for treating the interest rates and mortality tables of section 417(e)(3) and ERISA section 205(g)(3) as general purpose actuarial factors,

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[224] 1996-1 C.B. 359.

[225] *See* I.R.C. § 417(e)(3)(A)(i); *see also* ERISA § 205(g)(3)(A)(i).

[226] *See* I.R.C. §§ 417(e)(1),-(2), 411(a)(11); *see also* ERISA §§ 205(g)(1), -(2), 203(e).

The government-supplied interest rate of section 417(e)(3) and ERISA section 205(g)(3) is also used in the context of contributory defined benefit plans to determine the portion of the employee's benefit attributable to the employee's own contributions. *See* I.R.C. § 411(c)(2)(B), -(C); *see also* ERISA § 204(c)(2)(B), -(C). Here, again, a searching reading of the text confirms the limited role of these government-supplied interest rates. The statutes provide, in the contributory defined benefit setting, for a determination of the participant's overall benefit, a determination of the participant's benefit attributable to her own contributions, and the subtraction of the participant's self-financed benefit from her overall benefit to determine the balance of her benefit attributable to employer contributions. The statute only mandates the use of the government-supplied interest rates to determine the portion of the benefit attributable to the employee's contributions, not to determine the overall benefit, a determination which, as a statutory matter, is controlled by the plan's stated actuarial assumptions per section 401(a)(25).

[227] Under this statutory scheme, it is possible that a plan distribution will be greater than $5000 for purposes of requiring the participant's consent to immediate payment (since the government-supplied rates are used for this calculation) but less than $5000 for actual distribution purposes (since the plan's stated actuarial assumptions are used for this calculation). If, for example, the plan's interest rate is higher than the government-supplied interest rate, the lump sum value of an annuity will be greater using the lower government-supplied rate. Of the many anomalies created by the elaborate regulation of defined benefit plans, this strikes me as among the minor ones.

and, indeed, such treatment conflicts with Code section 401(a)(25) which mandates that plans use their own stated actuarial assumptions.

However, Notice 96-8[228] and the Regulations[229] propound a broader role for the government-supplied interest and mortality factors, mandating that such factors[230] be used for all calculations relative to pension lump sums, not just for the preliminary question whether or not pension benefits are immediately distributable in lump sum form. There is no basis in the text for this overly expansive approach to the statutes and for thus displacing the stated actuarial assumptions of the plan.

In its amicus brief in the *Georgia-Pacific* case,[231] the federal government advances three arguments for sustaining the Regulations and their mandate that the government-supplied assumptions be used broadly, not just to calculate the threshold for employee consent to immediate payment.[232] First, the government argues that employees need the protection of the government-furnished rates to prevent employers from using artificially high interest rates to lower the values of employees' lump sum distributions.[233] Second, the pre-1994 version of the relevant statutes is reasonably read as mandating the government-supplied actuarial factors for all payment purposes, that is, for determining the actual amount of each employee's lump sum distribution, and not just for assessing whether that distribution meets the threshold for employee consent for immediate payment.[234] Third, the government contends that the legislative history of the 1994

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[228] 1996-1 C.B. 359.

[229] *See* Treas. Reg. §§ 1.411(a)-11(d), 1.417(e)-1(b)(2)(ii), 1.417(e)-1T(d).

[230] The notice permits sponsors of cash balance plans to use, with modifications, certain interest rates based on their "historical relationship" to the government-supplied rate, that is, the rates on Treasury securities with a 30-year maturity.

[231] Jerry L. Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan, No. 99-10640-GG (11th Cir.) (pending before the court as of February 24, 2000).

[232] Brief for the United States as Amicus Curiae, Jerry L. Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan, No. 99-10640-GG (11th Cir.) (pending before the court as of February 24, 2000).

[233] *See id.* at 16-17 (stating "[i]t is therefore apparent that, in the absence of the provisions of Treas. Reg. Section 1.411(a)(11), pension plans could entirely circumvent the protections Congress intended to afford plan participants in specifying the interest rates that plans must use in determining the present value of participants' accrued benefits.").

[234] *See id.* at 6-8.

amendments to the statutes prescribes the use of the government-supplied actuarial assumptions to translate annuity benefits into lump sum equivalents, not just to assess whether the lump sum meets the $5000 threshold for employee consent for immediate payment.[235]

None of these arguments provides a convincing defense of the Regulations under the current statutes. As a legal matter, the issue is not the wisdom of these statutes but their meaning. While the construction of statutes is not a mechanical process nor one which should be undertaken with disregard for the consequences of alternative interpretations,[236] there are statutes which leave an objective reader with no reasonable doubt as to their literal meanings. Consequently, these statutes afford the reader no room to implement her policy predilections. Sections 411(a)(11) and 417(e)(3) and ERISA sections 203(e) and 205(g)(3) are such statutes. They explicitly restrict the government-supplied interest rates to the determination whether or not the $5000 threshold for employee consent has been triggered.

There is, moreover, a tenable policy justification for this outcome. ERISA, it is widely recognized,[237] is a balance of conflicting interests. Most apparently, the pension statutes reflect the tension between the desire to protect employees and the offsetting concern that employers and plans not be over-regulated to the point of deterring establishment of qualified plans. The approach embodied in the current version of sections 417(e) and 411(a)(11) and ERISA sections 205(g) and 203(e) is thus one of many trade-offs embedded in the pension law. Government-supplied actuarial factors must be used for some purposes (testing for the $5000 threshold for employee and spousal consent for

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[235] *See id.* at 10. The government's brief in *Georgia-Pacific* also discusses the legislative history of the pre-1994 version of the statutes. *See id.* at 8-10. The government's interest in this legislative history is not surprising since the earlier version of the statutes applies to the distribution at issue in *Georgia Pacific*. That earlier history, on the other hand, is quite removed from the question addressed in the text, that is, whether the Treasury Regulations are valid under the current version of the statutes.

[236] *See, e.g.*, Edward A. Zelinsky, Travelers, *Reasoned Textualism, and the New Jurisprudence of ERISA Preemption*, 21 CARDOZO L. REV. 807 (1999); Zelinsky, *Text, Purpose, Capacity and* Albertson's: *A Response to Professor Geier*, *supra* note 210.

[237] *See, e.g.*, Zelinsky, Travelers, *Reasoned Textualism, and the New Jurisprudence of ERISA Preemption*, *supra* note 236, at 862-63.

immediate lump sum payment) but not for others (determining the precise amount of any lump sum distribution). When the plan's actuarial assumptions control, these must be explicitly stated to preclude employer favoritism towards particular participants. For purposes of the present discussion, the question is not whether another balance could reasonably be struck; the issue is whether the statute strikes this particular balance. I believe it does.

In its *Georgia-Pacific* brief, the government plausibly contends the pre-1994 versions of the statutes[238] contemplate that the government-supplied interest rate will be used more broadly, not just to assess the $5000[239] threshold, but to determine the actual amount of the participant's lump sum distribution. In particular, section 411(a)(11) and ERISA section 203(e), in their pre-1994 incarnations, provided two interest rates, one which applied when lump sum distributions exceeded $25,000.[240] It is a plausible construction of this two interest rate structure that the statutory interest rates were intended for more than assessing the $5000 threshold since a second interest rate applicable above $25,000 implies broader use of that second figure. However, there is no basis for reading the current version of the statutes (with a single interest rate) the same way as the pre-1994 statutes with their dual rate structure. At its most basic, the Treasury's argument ignores the language now on the statute books and treats the 1994 amendments to the statutes as a legislative inadvertence. But legislatures change the law by amending statutes.

Finally, the limited reference[241] in the 1994 legislative history cited in the government's *Georgia-Pacific* brief cannot overcome the unambiguous language of the statutes which, on their face, restrict the role of the government-prescribed actuarial

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[238] Technically, the government's brief in *Georgia-Pacific* just discusses the Code version of the statute. *See* Brief for the United States as Amicus Curiae, Jerry L. Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan, No. 99-10640-GG (11th Cir.) (pending before the court as of February 24, 2000). However, the ERISA version was and is identical.

[239] To be precise, under section 411(a)(11) and its ERISA counterpart (ERISA § 203(e) (1984), as in effect before the 1994 amendments), the threshold figure was $3500.

[240] *See* I.R.C. § 411(a)(11)(B) (1984); *see also* ERISA § 203(e)(2)(A) (1984).

[241] The passage cited by the government in its *Georgia-Pacific* brief consists of two sentences from the House Report. *See* Brief for the United States as Amicus Curiae, Jerry L. Lyons v. Georgia-Pacific Corp. Salaried Employees Retirement Plan, No. 99-10640-GG (11th Cir.) (pending before the court as of February 24, 2000), at 10.

assumptions to the determination whether or not a distribution triggers the $5000 threshold for employee consent to immediate payment.

In this case, as in others, dispute about literal fidelity to statutory text is ultimately a dispute about the forum in which policy is to be made.[242] Perhaps the 1994 amendment of section 411(a)(11) and ERISA section 203(e) was, indeed, a legislative accident. The question becomes: who should correct that accident? My answer is Congress. Until Congress acts, reasonable respect for a scheme of statutory law requires that we assume the statute as enacted is the law, not a mishap.

C. Comprehensibility and Portability

Turning to issues of policy, I am skeptical of the argument that employers embrace cash balance plans because such plans, by virtue of their pseudo-account balances, are more comprehensible to employees and because such plans, by virtue of the greater portability of lump sum distributions, are more attractive to mobile workers. With reasonable effort, employers can reconfigure traditional final average plans to create *ersatz* account balances and to make benefits payable as portable lump sums. There is no need to convert to the cash balance format to present benefits in the language of individual accounts or to make benefits immediately distributable upon an employee's termination of employment.

Every annuity-based pension benefit can be translated into its present value, a value that constitutes a notional account balance, a lump sum equivalent of the annuity earned by the employee. Employees participating in traditional pension plans can be furnished with two formulations of their benefit: (1) the annuity form (as an annual income starting at retirement); and (2) the present value form (as a lump sum equivalent payable currently). Year-to-year increases in the latter number can function as year-to-year account balance increases, in precisely the same manner as year-to-year increments under cash balance plans can. In short,

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[242] *See* Zelinsky, Travelers, *Reasoned Textualism, and the New Jurisprudence of ERISA Preemption*, *supra* note 236, at 861-62.

making defined benefit plans look like individual account arrangements is a matter of presentation, not plan design. Traditional, final average pensions can be presented in mock defined contribution form via lump sum values.

As to portability, traditional annuity-oriented pensions can provide participants with the same lump sum distribution option as defined contribution and cash balance plans, i.e., the right to demand immediate distribution upon the termination of employment. Thus, if the employer wants, an employee in a final average plan can, while working, monitor the lump sum present value of her pension benefit like an account balance. Then, upon termination of employment, the employee can demand immediate payment of that lump sum to her directly or to an eligible retirement plan for the employee.[243]

D. The Intergenerational Distribution of Pension Benefits and the Psychological Reality of Expectations

The fact that traditional annuity-based pensions can be made to look like defined contribution arrangements (by informing the employee of the lump sum present value of her pension interest) and to act like such arrangements (by giving the employee the right to demand a lump sum payment upon the termination of employment) suggests that the underlying issue of the cash balance controversy is neither comprehensibility nor portability, but the intergenerational distribution of pension benefits. Traditional pensions pay more to older workers; defined contribution formats, including cash balance plans, are better for younger persons.

At this point in the analysis, the conventional critique of cash balance plans, with its focus on the conversion of existing pension arrangements, becomes internally inconsistent. No critic of cash balance plans suggests that the defined contribution motif should be abolished per se even though, in annuity terms, defined contribution plans provide greater benefits for younger persons. Indeed, no critic of cash balance plans attacks the creation of cash

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[243] *See* I.R.C. § 401(a)(31) (concerning direct, trustee-to-trustee rollovers).

balance arrangements *ab initio*. The question thus becomes: if the intergenerational impact of defined contribution and cash balance plans is acceptable when such plans are created from scratch, why should it be impermissible to switch an existing final average plan to the cash balance format?

The oft-stated answer – that such a switch breaks the employer's promise to its employees – is, as a matter of law, wrong. Employers typically reserve the right to amend and terminate their plans. Current law protects the accrued benefits the employee has already earned, not the right to earn additional benefits in the future.[244] Is there, then, a logical basis for the sense that, despite the employer's right to terminate or amend its traditional pension plan, cash balance conversions disappoint employees' extra-legal expectation that the employer will continue that plan indefinitely in its current form? I know of no such basis nor have the critics of cash balance plans suggested any.

Thus, I conclude that the very real anger generated by cash balance conversions[245] is ultimately a matter of psychology, the innate tendency of human beings to assume a sense of entitlement in the status quo even when they have no contractual or other legal claim to the status quo.[246] The sense of betrayal on the part of employees affected by cash balance conversions is sincere and deeply-felt, notwithstanding that, as a legal and logical matter, they have no right to assume the continuation of the pension plan in the form with which the employees are familiar. Employee anger ultimately stems from the psychological fact that, notwithstanding employers' legal rights to change their pension

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[244] *See* I.R.C. § 411(d)(6)(A).

[245] Anyone who doubts the depth or the sincerity of employee hostility towards cash balance conversions should visit the web site established by IBM employees dedicated to providing information on the IBM pension. *See IBM Pension and EIBAC Site* <http://www.ibmpension.freeservers.com> (visited on Mar. 4, 2000). *See also* Ira Sager & Aaron Bernstein, *Look For The Union Label – At IBM*, BUS. WK., Oct. 11, 1999, at 46.

[246] Particularly helpful in this context is the concept of status quo bias and the experiments conducted to explore this concept. *See, e.g.*, Daniel Kahneman, et al., *Anomalies: the Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSPECTIVES 193 (1991); AMOS TVERSKY & DANIEL KAHNEMAN, REFERENCE THEORY OF CHOICE AND EXCHANGE 5-7 (Stanford Center on Conflict and Negotiation Working Paper No. 9, May 1990). For the present discussion, the critical notion is the psychological tendency of individuals to assume the status quo as normative despite the absence of contractual or other legal claims to the status quo.

arrangements, employees expect that the existing arrangements will continue indefinitely. In simple terms, human beings do not think like lawyers.

The expectation that the pension status quo will persist can be formulated in terms of the implicit pension contract, discussed by Richard Ippolito and others.[247] From this vantage, while there is no explicit legal obligation to continue existing pension arrangements, there is an unstated agreement to do so, an agreement which manifests itself in lower cash wages.

The problem with implicit contracts is that they are, by their nature, implicit. The employee's understanding of the unstated bargain is often, quite reasonably, different from the employer's. Employees can plausibly characterize their acceptance of lower wages as consideration for the employer's implied commitment to maintain the current pension plan indefinitely. Employers can equally reasonably characterize the lower cash wages they pay as reflecting both the reality of existing pension coverage and the risk that such coverage might change in the future. From this perspective, current cash wages would be even lower if the employer guaranteed against that risk by committing to maintain the current pension plan indefinitely. The net result is that the theory of implicit contract does not extract us from the underlying dilemma of the cash balance controversy: employers have the legal right to alter pension arrangements while employees have deeply-held and sincere beliefs in their entitlement to the pension status quo.

These considerations manifest themselves in the particular sub-controversy about wear-away formulas. As a matter of law, an employer need not maintain any pension coverage for its employees. It is, thus, unsurprising that the current nondiscrimination Regulations condone wear-away periods during which the employee effectively has no pension coverage since the cash balance formula is catching up with the level of benefits previously accrued under the now-replaced traditional formula. While wear-away formulas may make sense given the premise that the employer is not obligated to maintain any qualified plan, the

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[247] *See, e.g.*, RICHARD A. IPPOLITO, PENSION PLANS AND EMPLOYEE PERFORMANCE 10-17 (1997).

cash balance controversy on another level is not about legal entitlements, but about psychological expectations. Wear-away arrangements run contrary to many employees' general beliefs that the pension status quo will continue indefinitely, and their particular expectations that they will continue to earn additional pension benefits during each year of future employment.

E. The Question of Disclosure

From the vantage of employee expectations, stronger disclosure rules are a minimalist response to the cash balance controversy, a response which leaves intact employers' legal right to alter their pension arrangements, which alert employees to the impact of cash balance conversions, and which leave ultimate resolution to private ordering, either through formal collective bargaining arrangements or less formal adjustments between employers and employees. There is an argument that the time has passed for mandating more detailed disclosure provisions on cash balance conversions. Ten years ago, few in the pension community, including myself, understood cash balance plans. Today, workers have been alerted to the significance of these plans. Indeed, the growing political controversy over cash balance conversions suggests that the critical absence today is not of information but of consensus. The success of IBM employees in forcing IBM to permit additional employees to stay with the traditional pension formula suggests that, at least for some parts of the workforce, the stakes in this controversy are well understood.[248]

The more serious problem with mandating additional disclosure is that the production of information is not costless. Disclosure may entail significant expense,[249] particularly if, as

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[248] *See IBM Changes Mind*, 27 PENSIONS & INVESTMENTS No. 19, Sept. 20, 1999, at 1 (noting that "IBM, yielding to employee pressure over its move to a cash balance plan, is more than doubling the number of workers who may choose to stay in its traditional defined benefit plan.").

[249] *See, e.g.*, Brian H. Graff, *Cash Balance Plans Under Attack*, 39 PENSION ACTUARY No. 3, May-June 1999, at 1, 9 (noting "ASPA's Government Affairs Committee believes that requiring individual benefit comparison statements for every participant will be extremely difficult and expensive for plan sponsors and may lead many employers to instead terminate their plans.").

some cash balance critics contend, participants should receive detailed, individualized actuarial projections as part of such disclosure.[250]

Current pension law is an aggregation of often well-meaning and reasonable policies, each of which is defensible incrementally and in isolation but which cumulatively have inflicted inordinate cost and complexity on the pension system generally, and the defined benefit system in particular. The widely-recognized over-regulation of qualified plans stems, not from the pressure of narrow special interests[251] but from the cumulative imposition of plausible, policy-driven mandates, often reinforced by fiscal considerations. These mandates have collectively made the pension law the morass it is today.

The problem is revealed in the formulaic incantation that we do not want to regulate defined benefit plans out of existence. This incantation is often followed by proposals for additional regulation. The over-regulation of pension plans will continue unless and until pension policymakers are prepared to eschew quite plausible proposals to avoid further burdening the pension system.[252] Since pension complexity is heavily policy-driven, such complexity can be abated only by sacrificing policy objectives.

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[250] One widely-discussed proposal is S. 1708, 106th Congress (1999), introduced in the House as H.R. 3047, 106th Congress (1999). This legislation would amend ERISA section 204(h) to mandate increased disclosure and to require the provision of certain data to individuals. *See* S. 1708, § 2 (amending ERISA § 204(h)). However, this legislation would exempt from some of its disclosure requirements plans with fewer than one hundred active participants. *See id.* (amending ERISA § 204(h)(3)). This legislation would also exempt large plans from having to provide "to an individual such individual's personal information." *See id.* (amending ERISA § 204(h)(4)(B)(flush language). Thus, S. 1708 (H.R. 3047), while it would impose greater disclosure requirements than those of current law, would not go as far as has been suggested by some.

In contrast, another prominent proposal, introduced as S. 1640, 106th Congress (1999) and as H.R. 2902, 106th Congress (1999), would impose upon plans with one hundred or more participants the obligation to produce particularized actuarial information for participants and beneficiaries whenever future rates of benefit accrual are reduced by plan amendment. *See* S. 1640, § 2(a) (adding I.R.C. § 401(a)(35)(c)(ii)), § 2(b) (adding ERISA § 204(h)(3)(c)(i)) (1999).

[251] In this respect, the pension provisions of the Code, heavily policy-driven, contrast with other portions of the tax law, significantly influenced by affected interests. On the policy-driven nature of the Code's qualified plan provisions, see generally Edward A. Zelinsky, *Another Look at Tax Law Simplicity*, 47 TAX NOTES (TA) 1225 (June 4, 1990).

[252] My pet proposal is a legislative rule which would permit a Congressman to propose an addition to pension complexity but only if there is an offset, i.e., two provisions of equal complexity he would simultaneously repeal.

F. Approach One: the Best of All Worlds

From all of this, I conclude that, if we lived in the best of all worlds,[253] Congress would retroactively[254] amend section 411(b)(1)(H), ERISA section 204(b)(1)(H), and ADEA section 4(i)(1)(A) to permit cross-testing, that is to measure cash balance plan accruals for age discrimination purposes by looking at contributions rather than at annuity equivalents. There is no reason to characterize, as the current statutes do, true defined contribution plans as age-neutral but to characterize *ersatz* defined contribution/cash balance arrangements as age discriminatory because contributions' annuity equivalents decline as participants age.

I would also amend the statutes to establish that cash balance conversions with wear-away features not be considered as age discriminatory. Given the premise that employers need not establish any qualified plan, it is difficult to see why the hiatus of coverage caused by wear-away provisions should be outlawed.[255] Beyond this, I would leave the matter of cash balance conversions to private ordering, collective bargaining in the unionized sector, less formal negotiation and adjustment in the non-unionized portions of the economy. Not every controversy requires a legislative response.

If I were representing or advising employers,[256] my inclination would be to accommodate, as far as reasonably possible, employees' psychological expectations about the maintenance of the pension status quo through generous transition arrangements.

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[253] This phrase should probably be read: "If I alone could make pension policy."

[254] If I am correct that, as a matter of policy, there is no reason to declare cash balance conversions as age discriminatory, I see no reason to adopt the proper policy on a prospective basis only. Hence, my recommendation that the statutes be changed retroactively.

[255] My argument is that the statutes should permit wear-away provisions. However, for many employers and in many contexts, I would view as wise the decision to eschew or limit wear-away formulas. My point is that the choice to utilize wear-away provisions (or not) should not be legislated but should reflect the decentralized responses of employers, employees, and the unions which represent them.

[256] In fact, I do not represent either employers or employees concerned about cash balance plans and, in accordance with my normal practice, will not engage in such representation while commenting academically on this controversial issue. My comments are, in the best (and perhaps the worst) sense of the term, "academic."

While there is no legal or logical underpinning to those expectations, they are sincere and deeply-held and therefore must be addressed by any employer interested in a good relationship with its workforce. However, as a matter of policy, there is no compelling argument for legislation beyond the modification of the age discrimination tests for cash balance plans.

G. Approach Two: Confronting the Political Realities

Nevertheless, the political reality is that the cash balance controversy is unlikely to be resolved in this fashion, given the deeply-held and sincere response of those employees affected by cash balance conversions. My hope, therefore, is that a package can be crafted which responds to political imperatives without creating yet another difficult hurdle to the creation and maintenance of defined benefit plans.

By definition any package of proposals will involve judgments and trade-offs. I perceive a reasonable package as having four elements. First, as just noted, Congress would amend section 411(b)(1)(H), ERISA section 204(b)(1)(H), and ADEA section 4(i)(1)(A) so that cash balance plans will test for age discrimination like defined contribution plans, that is, on the basis of contributions and not annuity equivalents and so that wear-away provisions will not run afoul of age discrimination rules. Second, Congress would amend the Code and ERISA to confirm statutorily the Treasury's position that the government-supplied interest rates and mortality tables must be used to calculate the actual amounts of lump sum distributions from defined benefit plans. Third, Congress would cap wear-away provisions in the context of cash balance conversions. Thus, cash balance formulas could only freeze future benefit accruals for a limited period (for example, two years) after which all cash balance participants would earn additional benefits.[257] Fourth, congressionally-mandated notification would take the form of a standard, IRS-promulgated statement which, at little cost, employers could distribute to

[257] I would not limit wear-away formulas outside the cash balance context.

employees.[258] Hopefully, this package could be sweetened by adding some general pension simplification measures.

V. CONCLUSION

As a matter of law, the typical cash balance plan violates the statutory ban on age-based reductions in the rate at which participants accrue their benefits. However, as a matter of policy, there is no sound reason to proscribe cash balance arrangements nor is there a convincing legal or logical basis for the anger spawned by the transformation of conventional final average pension plans to the cash balance motif. Indeed, cash balance plans represent a reasonable alternative which permit employers to remain within the defined benefit system.[259] As a matter of psychology, the bitterness against cash balance conversions largely stems from psychological expectations in the continuation of the status quo, rather than any legal or logical entitlement to the continuation of existing pension coverage.

Theoretically, the proper resolution of the cash balance controversy would be to alter the statutory prohibitions on age-based reductions in benefit accrual rates and to allow private ordering between employers and employees (or their unions) to govern such conversions. Since we do not live in the best of all worlds, as a matter of politics, a package of legislative compromises is probably the best we can do. We can only hope that package, while responding to the political realities of the situation, will not further burden the creation and maintenance of

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[258] I would not inflict on employers the cost of individualized actuarial projections for each employee. Some have suggested that, in response to the plight of small employers, such employers be exempted from any notification proposal. Thus, for example, notification to participants would be required only if the employer had more than one hundred participants in the plan being converted to the cash balance motif. The dilemma presented by this approach is that notification will be most costly per participant for smaller employers lacking economies of scale, but some smaller employers' workforces will be the audiences most likely to benefit from disclosure. My proposal escapes this dilemma by mandating relatively inexpensive disclosure through a standard IRS form, thereby reducing costs for all employers, including small ones.

[259] *See* Lurie, *supra* note 210, at 510 (stating "if the mass exodus from [defined benefit plans] is to be halted – as most professional observers of the pension scene hope will occur (viewing defined benefits plans as better safeguards of retirement security) – it will be the [cash balance plans] that accomplish this").

defined benefit plans.