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Defined Benefit Plans in an Era of Phased Retirement

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Abstract

The concept of retirement is changing. Instead of viewing retirement as the end of a career, many people are using this time to try new careers or to scale back on current ones. As such, many retirees are now considering "phased retirement" in which a person does not withdraw completely from the workforce, but chooses to work in a reduced capacity, as a part-time or temporary employee. To retain and attract phased retirees, employers will need to offer different compensation options.

One such option is to offer participation in a defined benefit plan. Most phased retirees have some retirement funds available, but due to extended life expectancy and increasing medical costs, they may not have adequately prepared for the cost of retirement. Therefore, earning an additional pension, or additional pension credits, during phased retirement would be a significant opportunity for such retirees. This paper explores the advantages and disadvantages of a defined benefit plan option for phased retirees.

It ought to be lovely to be old
To be full of the peace that comes of experience
And wrinkled ripe fulfillment.
-*Beautiful Old Age* by David Herbert Lawrence

I. Introduction

Retirement should be "lovely," allowing retirees to enjoy "peace" and "fulfillment" that are much deserved. However, the economic reality facing future retirees threatens the "peace" and "fulfillment" of retirement. The oldest baby boomer turns 56 this year.[1] This means that the largest segment of the population is entering into retirement age. In addition to the sheer number of future retirees, longer life expectancies and rising healthcare costs threaten their financial security. Moreover, the uncertainty of the Social Security system casts doubts for many people on their financial security in retirement.

Retirement benefits were once the concern only of retirees. However, over the past two decades, they have become the focus of all members of today's workforce, as people begin to change their perceptions of retirement funding.

In addition to funding issues, the image of retirement is also changing. Not so long ago, an employee was expected to spend most, if not all, of his or her working life with one employer, retire at age 65, with a small pension benefit, then spend all day playing golf and fishing. However, as times have changed, the expectations of employees concerning employment, retirement, and retirement benefits have also changed. Unlike previous generations, the current one does not expect to spend twenty to thirty years with one employer. Moreover, the concept of a traditional work arrangement is changing. The percentage of the workforce engaged in non-permanent or less than full-time employment is approximately 30% and growing.[2]

The concept of retirement is also changing, as many workers now foresee being employed during their retirement years. Many retirees are now considering "phased retirement" in which a person does not withdraw

[1]The Segal Company Newsletter, Vol. 45, No. 1, June 2001.
[2] Advisory Council on Employee Welfare and Pension Benefit Plans, U.S. Dep't of Labor, Report of the Working Group on the Benefit Implications of the Growth of a Contingent Workforce: (November 10, 1999).

completely from the workforce, but chooses to work in a reduced capacity as a part-time or temporary employee.

One option that would be beneficial to phased retirees is participation in a defined benefit plan. Phased retirees probably have retirement funds available. However, due to extended life expectancy and increasing medical costs, phased retirees might not have adequately prepared for the cost of retirement. Therefore, earning an additional pension, or additional pension credits, while in phased retirement would be a significant opportunity for such retirees.

Defined benefit pension plans are considered by many as retirement tools of the past, because they signal a long-term expense for employers. This sentiment is not far from the truth, as administration and costs are considered unduly burdensome for employers, notwithstanding rich benefits for employees. Now that work and retirement patterns are changing, the defined benefit plan may be useful as a compliment to other retirement benefits. Even more so in the current climate of falling stock prices, defined benefit plans are considered "safe" retirement vehicles. Consequently, this study proposes that a defined benefit option for phased retirees could supplement the increasing cost of retirement.

This paper will look at the defined benefit plan option as a valuable tool for retaining and attracting workers in phased retirement. It begins by explaining the rising trend of phased retirement, then discusses why employers and employees might favor defined benefit plans in the current economic and demographic climate. Finally, the paper discusses regulatory and statutory issues that affect defined benefit plans.

II. Greater Numbers of Retirees are Choosing Phased Retirement

The concept of retirement has changed and continues to change. Retirement is no longer considered to be void of employment; rather, a growing number of employees are looking forward to a retirement that includes employment, albeit part-time or temporary work.[3] Eight in ten baby boomers

[3] Interest in part-time employment rises with age as older workers are more likely than their younger counterparts to work part-time by choice. For example, as of 1997, 39% of working women age 55 or older were voluntary part-time workers; the comparable figure for women under the age of 55 was 28%. Just 23% of older men chose to work part-time, but that was the case for only 13% of younger men. AARP Update on the Older Worker: Participation Rises and Unemployment Falls (1997).

say that they plan to work at least part-time during their retirement; whereas, only 16% say that they will not work at all. Moreover, the removal of the earnings cap for retirees between the ages of 65 and 69 is expected to encourage recent retirees and those nearing retirement to continue working and to help ease employers' hiring needs in the tightening labor market.[4]

Employers are also beginning to view retirement differently. Many employers are adopting phased retirement approaches to retain senior employees. They consider phased retirement a benefit to their business because it helps retain skilled workers, facilitates training new workers, and can control early retirement costs.[5] Thus, for both employer and employee, phased retirement can be a beneficial experience.

However, employees who continue to work after retirement may be sacrificing pension benefits. Due to benefit design constraints, as a class of part-time or temporary employees, phased retirees might not have the rights and privileges of full-time employees with respect to pension benefits. Also, they may not be eligible to participate in an employer-sponsored pension plan.

Furthermore, employers who permit phased retirement arrangements are likely to discontinue benefit coverage that is similar to the coverage of full-time employees.[6] In particular, employers cover 59% of full-time employees under a defined benefit plan; whereas, only 29% of phased retirees are covered under a defined benefit plan.[7] Such a result discourages phased retirement and both employer and employee lose the benefits of this arrangement.

Aside from the distinction of being in a particular class of employees, there are other hindrances to phased retirement. ERISA permits a plan to suspend an employee's pension payment if he or she continues to work for the same employer after reaching normal retirement age. Thus, a person who chooses to work during retirement may sacrifice some of his or her retirement

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[4] Christopher J. Gearon, *Legislation Courts Older Workers*, Population Reference Bureau: Population Today, August/September 2000. <http://www.prb.org/pt/2000/August2000/Legislation_Courts_Older Workers.html>.
[5] *Employers Turn to Phased Retirement as Workers Age and Labor Shortages Increase: The Business Case*, Watson, Wyatt Worldwide, News and Issues.
[6] *Research and Publications: Benefits for Phased Retirees.* Watson, Wyatt Worldwide (visited Nov. 9, 2000). <http://www.watsonwyatt.com/homepage/us/res/phasret3-tm.htm>.
[7] *Research and Publications: Benefits for Phased Retirees.* 2000. Watson, Wyatt Worldwide (Nov. 9, 2000) < http://www.watsonwyatt.com/homepage/us/res/phasret3-tm.htm >.

income if the plan is designed to suspend retirement income in this manner. Phased retirement can offer many potential benefits to both employers and the employee, but more work needs to be done to ensure that phased retirees receive pension benefits.

III. The Current Economic and Demographic Climate Favors Defined Benefit Plans

A defined benefit plan is a pension plan that provides a set benefit to a participant. Such benefit usually relates to the years of service earned under a plan. Generally, only the employer makes plan contributions, however, some plans do require employee contributions as well.

Employers have a number of reasons for favoring defined contribution plans over defined benefit plans. The primary reason is that defined contribution plans can be less expensive for the employer, particularly if the plan is based solely upon employee contributions. Also, the qualification rules for defined contribution plans are often easier to follow, especially with respect to accrual rules and funding standards.

Nevertheless, defined benefit plans offer a number of advantages. Primarily, a defined benefit plan can offer security to the employee.[8] In a good economy, participants reap significant rewards from investing in a defined contribution plan. On the other hand, if the economy is not good, participants may suffer from investing in a defined contribution plan. In addition, a defined benefit plan offers a continuous and consistent stream of income. Also, a defined benefit plan may offer less fiduciary risk than a defined contribution plan.

Furthermore, employees favor defined benefit plans. Asked to rank overall satisfaction with various work benefits on a scale of 1 to 10— with 10 being the highest — respondents most preferred defined benefit retirement plans (7.5), followed by defined contribution retirement plans (6.4).[9] The benefit that workers most requested, which was not being offered, was the defined benefit

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[8] Pamela D. PERDUE, Qualified Pension and Profit-Sharing Plans 14-15 (ed. 1998).

[9] *Investments – Workers concerned about Financial Future but Expecting to Stick with Investment Plans,* Pension & Benefits Daily (Volume 01, Number 100) May 23, 2001 <http://pubs.bna.com/ip/BNA/pbd.nsf/id/a0a4f4w7r0_>.

plan option (24%).[10] Consequently, there are several advantages to a defined benefit plan for both employers and employees.

A. Defined Benefit Plans Offer Financial Security

The defined benefit plan is attractive because it offers a guaranteed benefit that does not depend upon market fluctuations. Over the last two decades, the financial risk of retirement funding has shifted from employers to workers and retirees due to the switch from defined benefit to defined contribution pension plans.[11] The decrease in defined benefit pension plans adds risk to the retirement years, because retirees become dependent on their own investments.[12]

A survey commissioned by SunAmerica, Inc. found that 39% of those polled believe that their retirement plan is not safe and 41% believe that their retirement plan is not working hard enough to achieve their goals.[13] Moreover, the research revealed that although the economic boom of the 1990s popularized "do-it-yourself" investing, the recent economic downturn has left a bitter taste in the mouths of retirees and reduced participants' confidence in their own ability to make sound financial decisions and effectively plan for their financial future.[14]

These perceptions have been validated by a recent review of 401(k) accounts. For the first time in the 20-year history of the 401(k) plan, the average 401(k) account lost money last year.[15] Although the downturn in the market affected account values, the report discovered that many people were not investing properly.[16] Defined benefit plans, on the other hand, offer a set benefit that can be determined without regard to economic swings or individual investment errors.

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[10] *Investments – Workers concerned about Financial Future but Expecting to Stick with Investment Plans,* Pension & Benefits Daily (Volume 01, Number 100) May 23, 2001 <http://pubs.bna.com/ip/BNA/pbd.nsf/id/a0a4f4w7r0_>.

[11] *Retirement Policy–AARP Issues 'Wake-up Call' for Families, Policymakers to Rethink Economic Strategies,* Pension & Benefits Daily (Volume 01, Number 101) May 24, 2001.

[12] *Older Americans Fare Well, For The Most Part,* The Inquirer, May 24, 2001 <http://inq.philly.com/content/inquirer/2001/05/24/business/PERS24.htm?template=aprint.htm>.

[13] *Half of Baby Boomers Have Neglected Their Retirement Plans, Survey Shows,* SunAmerica News, June 6, 2001 <http://www.sunamerica.com/InFocus/News/010606.htm>.

[14] *Half of Baby Boomers Have Neglected Their Retirement Plans, Survey Shows,* SunAmerica News, June 6, 2001 <http://www.sunamerica.com/InFocus/News/010606.htm>.

[15] Danny Hakim, *401(k) Accounts Are Losing Money for the First Time*, The New York Times, July 9, 2001.

[16] Danny Hakim, *401(k) Accounts Are Losing Money for the First Time*, The New York Times, July 9, 2001.

Employers fund defined benefit plans and professionally invest their assets for the long-term. Because defined benefit plans are generally maintained for long periods of time, their assets are invested on the basis of a long-term time horizon, without being unduly influenced by temporary market trends. A defined benefit plan, unlike an individual with other things to do and who is perhaps closing in on retirement, can take a longer view and often a less conservative position in the marketplace.[17]

Moreover, benefits from a defined benefit plan are generally paid over the life of the participant. A defined contribution plan pays only the participant's account balance; it is then up to the participant to ensure that the account balance will last for the rest of his or her lifetime. Faced with the reality of longer life expectancies, phased retirees would be able to depend upon a traditional pension benefit for the duration of the retirement period, rather than spreading a set amount from a defined contribution account over a longer retirement period. Thus, for a number of reasons, a defined benefit plan provides a more reliable benefit than a defined contribution plan.

Despite the security of defined benefit plans, fewer retirees will be covered by them. The number of pre-retiree households participating in defined benefit plans, but not in defined contribution plans, fell from 25.9% in 1989 to 12.5% in 1998; whereas, the number participating in defined contribution plans, but not in defined benefit plans, rose from 13.4% to 26.8%. The number of households covered by both types of plans fell from 16.5% to 12.8%.[18] Furthermore, it appears that this trend will continue. Of today's retirees, men receive 39% of their retirement income from defined benefit plans and women receive 49.7% from define benefit plans. However, of pre-retirees, men will receive only 26.4% of their retirement income from defined benefit plans and women will receive 37.2%, a decline of 32.4% and 25%, respectively.[19]

[17] Mark J. Ugoretz, President of the ERISA Industry Committee, Before the U.S. Department of Labor ERISA Advisory Council Working Group on exploring the possibility of using surplus pension assets to secure retiree health benefits, July 13, 1999.
[18] *Older Americans Fare Well, For The Most Part,* The Inquirer, May 24, 2001 <http://inq.philly.com/content/inquirer/2001/05/24/business/PERS24.htm?template=aprint.htm>.

[19] *Retirement Income Shifts Challenges Young Baby Boomers: EBRI*, Plansponsor.com, May 1, 2001 at <http://www.plansponsor.com/content/news/finance/ebriboomer>.

B. Defined Benefit Plans May Offer Less Risk of Fiduciary Breach

For 20 years, defined contribution plans have experienced widespread success. As a result, fiduciary responsibilities for defined contribution plans have not been tested. However, with a downturn in the market, employers risk accusations of fiduciary breach. The Foundation for Fiduciary Studies has reported that fiduciary liability is one of the fastest growing areas of litigation in the country. "We are facing a social crisis in this country in the next 10 to 15 years when a large component of the work force realizes they have not saved enough for retirement, and Social Security is not able to handle them."[20]

Participants who realize that they do not have sufficient assets for retirement may blame their employers for the performance of their 401(k) accounts and, subsequently, pursue litigation.[21] As seen in cases against Enron Corporation and Lucent Technologies, Inc., the implementation of defined contribution plans can lead to a substantial risk of a breach of fiduciary liability. The extent of this risk remains to be seen as these cases unfold.

Although defined benefit plans are still susceptible to claims of fiduciary breach, the law is more settled, and, therefore, there is less risk of unknown requirements arising. Thus, for phased retirees, the additional pension accrual, in combination with the additional income, could help them maintain a comfortable lifestyle for the remainder of their lives.

C. Employer-Provided Retiree Health Benefits are at Risk

Retiree health care costs are likely to become a greater concern to plan sponsors than they are today because of the sheer number of people who will need retiree health care. Retirees will require more years of health coverage, as increases in life expectancy will give them more retirement years.[22] Moreover, the cost of retiree health coverage will be borne by fewer active participants, because the generation that follows the baby boomers is smaller.[23] In addition, retirees account for a greater proportion of health costs. People aged 65 and

[20] Clare Howard, *Companies Should Anticipate Litigation Related to Employees' 401(k) Plans*, Peoria Journal Star, July 9, 2001, quoting Don Trone, President of the Foundation for Fiduciary Studies.
[21] Clare Howard, *Companies Should Anticipate Litigation Related to Employees' 401(k) Plans*, Peoria Journal Star, July 9, 2001, quoting Don Trone, President of the Foundation for Fiduciary Studies.
[22] The Segal Company Newsletter, Vol. 45, No. 1, June 2001.
[23] The Segal Company Newsletter, Vol. 45, No. 1, June 2001.

older accounted for 41% of personal health care expenditures in 1995 although they represented just over 10% of the population.[24]

Recent court decisions concerning health care coverage are predicted to increase the cost of maintaining employer-sponsored health coverage. This paper does not offer any conclusions on the merits of the following actions, only that they will increase costs for employers. One of these changes alone might not be significant, but taken together and in addition to increased costs based upon demographic changes, the costs of providing a health care plan may become unduly burdensome for some employers.

1. <u>Compliance with the ADEA May be too Costly for Employers</u>

In *Erie County Retirees Association, et al. v. the County of Erie, Pennsylvania, et al*, (No. Civ. A. 98-272 (April 16, 2001)), the court found that the provision of disparate health care coverage between Medicare-eligible retirees and retirees younger than age 65 violated the Age Discrimination in Employment Act ("ADEA").[25] Many plan sponsors and employers were surprised by this case because it was generally believed that retiree benefits were immune from the requirements of the the ADEA. However, the Third Circuit held that the ADEA does apply to health care benefits for retirees and, on remand, the district court found that the Medicare-eligible retirees did not receive equal benefits under the equal benefit or equal cost standard.

Many of today's retiree health plan designs would not satisfy the ADEA based on the *Erie* ruling and analysis. For example, plans that offer reduced benefits to retirees age 65 and over might not comply. Plans that charge all retirees the same contribution amount could fail the equal percentage contribution test, since the employer's costs decrease after employees become eligible for Medicare.

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[24] The Segal Company Newsletter, Vol. 45, No. 1, June 2001.
[25] The effect of *Erie* is uncertain at this time. The Equal Employment Opportunity Commission is currently reconsidering its support of the *Erie* decision. It has closed current cases pending further review by an internal task force. Moreover, a bill was introduced into the House of Representatives on July 18, 2001, to amend the ADEA with respect to medical benefits. Specifically, the bill provides that medical benefits of retired participants that are altered, reduced, or eliminated when the participant is eligible for Medicare shall not violate the ADEA. (H.R. 2558). Consequently, there could be future Congressional or administrative action that would negate the effect of the *Erie* decision.

Erie raises many issues and concerns for employers who provide retiree benefits. Although the EEOC has subsequently discontinued enforcement of these violations, *Erie* still stands. Therefore, until the issue is definitively settled by the Supreme Court or Congressional action, an element of uncertainty remains. Consequently, employers must decide whether to try to comply with *Erie* or wait for further guidance. Those employers who want to comply with *Erie* have little guidance to follow. Although the *Erie* case answers some questions about the equal benefit or equal cost standard, the highly factual nature of the analysis will require many more cases to provide a comprehensive guideline for the analysis. At the very least, even plans that are compliant will have to expend time and costs to consult with professionals so they may ensure compliance with the ADEA. If this case is followed by other courts, it could become prohibitively expensive for employers to provide health care benefits to retirees. Although this case does not go so far, one ultimate conclusion is that active and retired employees must receive the same coverage. Such a result could drive employers away from providing any type of health care coverage. Consequently, extra income during retirement would become even more vital.

2. <u>Requiring Employers to Cover Prescription Contraceptives Could Increase Costs</u>

On June 12, 2001, a federal district court in Seattle decided that the exclusion of benefits that were relevant only to women, such as prescription contraceptives, from a comprehensive prescription drug program is discriminatory under Title VII of the Civil Rights Act of 1964.[26] In the case, the employer's self-insured plan covered prescription drugs, but excluded all prescription contraceptives. The court ordered the employer to cover all "available options for prescription contraception to the same extent, and on the same terms" that it covered other drugs, devices and preventative care for employees in that health plan.[27] In addition, the court ordered the employer to offer coverage for contraception-related services, including the initial visit to the prescribing physician and any follow-up visits or outpatient services, to the same extent that it covered other outpatient services.

In a similar ruling, the Equal Employment Opportunity Commission ("EEOC") stated that two employers who failed to cover prescription contraceptives violated Title VII and the Pregnancy Discrimination Act

[26] *Erickson v. Bartell Drug Co.,* 141 F. Supp. 2d 1266 (W.D. Wash., 2001).
[27] *Erickson*, 141 F. Supp. 2d at 1277.

(“PDA”).[28] The EEOC ruled that if a health plan covers prescription drugs and devices, or other types of services to prevent the occurrence of other medical conditions, it must cover the full range of prescription contraceptives for adults and must offer contraception-related outpatient services on the same terms as other outpatient services.

In a narrower ruling in April 2001, a federal district court in Minnesota held that an employer can be sued under Title VII for sponsoring a health benefit plan that excludes coverage of oral contraceptives, but covered medically approved prescriptions for male hormonal disorders.[29] The court found that design of the plan provided unequal benefits for male and female plan participants.

Consequently, when an employer decides to offer a prescription benefit plan that covers everything except for a few specifically excluded drugs, it has a legal obligation to make sure that the exclusions are not discriminatory. These cases suggest that plans may need to cover more benefits than previously believed. Although it was not an issue in these cases, the question arises whether the exclusion of certain male-specific benefits (such as Viagra) could also expose an employer to risk under Title VII.[30] At the very least, the rulings in these cases leave plans open to potential litigation over benefits that are not currently covered.

3. <u>The Patient’s Bill of Rights Has Employers Worried about Cost</u>

Despite the lack of attention in the final months of 2001, patients' rights legislation is still a concern to employers. With the decline of the economy and the increase in health care costs, the issue of health care now becomes increasingly important. In early January of 2002, business groups announced renewed lobbying efforts to prevent a Patients' Bill of Rights.[31]

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[28] EEOC Commission Decision (Dec. 2000) <www.eeoc.gov/docs/decision-contraception.html>.
[29] *EEOC v. United Parcel Service*, Civ. File No. 00-2229 (PAM/JGL) (D. Minn. April 14, 2001). Can be found online at <http://www.mnd.uscourts.gov>.
[30] "Group Health Plan Must Cover Prescription Contraceptives." *EBIA Weekly*. June 14, 2001. <www.ebia.com/weekly/articles/HIPAA010614Erickson.html>.
Employers Vow to Fight Potential Deal on Patients’ Rights, Point to High Costs, , Pensions & Benefits Daily, January 25, 2001 at <http://pubs.bna.com/ip/BNA/pbd.nsf/id/a0a5d4g8u3_>.

Benefit professionals have stated that Patients' Bill of Rights legislation already has added substantially to cost trends.[32] For example, provisions in the Senate version of the bill would allow patients to sue health plans for damages in state court over medical judgment disputes and in federal court over contractual claim disputes. The threat of such litigation raises the costs of insurers and administrators as they anticipate greater expense due to such litigation.

IV. Retirees in Phase Retirement Would Appreciate a Defined Benefit Plan

A person who is working during retirement might not be able to contribute to a defined contribution plan because of reduced income. However, the ability to continue to accrue benefits under a defined benefit plan is attractive.

In 2000, 12.8% of people age 65 and older were in the work force—the most since 1979—according to the Labor Department. The older population is healthier and living longer, and, therefore, is more suited to continue working than Americans in the past.[33] As baby boomers increase in age, the need for workers in the workplace has increased.[34]

One way to decrease the strain on the labor market is to keep older, skilled workers in the workforce. Moreover, a study shows that older workers would be more likely to delay early retirement if they could earn increased Social Security or pension benefits.[35] Defined benefit plans could help in this area, by allowing older workers to accrue additional benefits while continuing to work, even if such work is not full-time.

Defined benefit plans may be particularly attractive to older employees. The defined benefit plan offers security that cannot be found in a defined contribution plan. Employees who are in semi-retirement might not want to

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[32] *Health Costs, Patient's Right Legislation Would Substantially Increase Cost, Analyst Says,* Pensions & Benefits Daily, July 16, 2001 at <http://pubs.bna.com/ip/BNA/pbd.nsf/id/a0a4k6b9f8>.
[33] Leigh Strope, *More Older Workers on Job,* June 5, 2001 <http://news.excite.com/printstory/news/ap/010605/01/retiring later>.
[34] Anthony Kane, *Older Workers Widen Role in Work Force* <http://www.smartbiz.com/sbs/arts/kanel.htm>.
[35] Anthony Kane, *Older Workers Widen Role in Work Force* <http://www.smartbiz.com/sbs/arts/kanel.htm>.

chance investing in the stock market because of the chance that a short-term investment would not produce favorable results. Therefore, a defined benefit plan, even one that pays a small benefit, may be viewed as a significant supplement to other forms of retirement income. It may also be viewed as a reliable asset that the employee can depend upon throughout retirement.

A. Defined Benefit Plans Can Aid in Meeting Greater Financial Needs

Americans are experiencing longer life expectancies, which means that a greater portion of a person's life is spent in retirement. Therefore, people will need more money to cover this increased life expectancy. A secure pension from a defined benefit plan could provide relief.

Life expectancy at age 65 has increased significantly in recent decades– 20% for women and 17% for men in the years 1960–1990.[36] Consequently, retirement savings will have to stretch further than before. It is expected that 4 in 10 Americans over the age of 60, regardless of their current economic circumstances, will experience poverty at some point in their later lives. The chances of a person in this age group experiencing near-poverty (falling below 125% of the poverty line) is even greater: 1 in 2.[37]

However, workers have not prepared for this greater expense. Sixty-one percent of all workers between 24 and 64 do not have a retirement savings account. Among the 42.5 million workers who had some kind of account in 1998, the average account had a value of $34,700 and the median amount put aside was $14,000. Among those of the pre-retirement age, 55–64, the median retirement account balance was less than $25,000.[38]

B. The Defined Benefit Plan as a Supplement to Health Care Coverage

In response to the rising cost of health care, employers are attempting to shift more of the cost to employees. PricewaterhouseCoopers has stated that employers increasingly will be moving to a define contribution system for health plans over the next several years in an effort to shield themselves from potential lawsuits and to address the growing push for consumer empowerment.[39]

[36] The Segal Company Newsletter, Vol. 45, No. 1, June 2001.
[37] *Retirement Policy – AARP Issues 'Wake-up Call' for Families, Policymakers to Re-think Economic Strategies*, Pension & Benefits Daily (Volume 01, Number 101) May 24, 2001.
[38] Scott Burns. *Retirement Savings – We're Still Behind the Curve,* The Dallas Morning News, June 5, 2001, <http://www.scottburns.com/010605TU.htm> reporting on *Retirement Savings and Household Wealth in 1998: Analysis of Census Bureau Data,* by Partick J. Purcell.
[39] *Employee Benefits–Employers Heading to Defined Contribution to Ward off Lawsuits, Address Consumerism,* Pension & Benefits Daily, June 5, 2001 <http://pubs.bna.com/ip/BNA/pbd.nsf/id/a0a4g4v1q4_>.

A defined benefit plan can be instrumental in providing health care coverage. A Code section 401(h) account can be used in a pension plan to provide benefits for sickness, accidents, hospitalization, and medical expenses for retired employees.[40] In addition to making contributions to a Code section 401(h) account, an employer can transfer excess contributions from a pension plan. Code section 420 allows certain transfers of excess assets from a defined benefit plan (other than multi-employer plans) to a retiree health account that is part of the plan, if the transfer is made before January 1, 2006.[41] Thus, a pension plan that exceeds its expected investment return can use the extra investment earnings to fund health benefits, thus, decrease the employer's health care cost without increasing the cost to employees.

A defined benefit option also could be used when an employer has to increase the cost of health care benefits or has to eliminate the benefit altogether. Rather than pay premiums, the employer offers the defined benefit pension, which can then be used to buy health insurance. This method controls the cost to an employer because the pension contribution stays constant, regardless of changes in healthcare costs. Moreover, this system offers flexibility to a phased retiree. A healthy phased retiree who is receiving Medicare may not want supplemental coverage. Thus, the pension can be used in the manner most beneficial to the phased retiree.

V. Plan Design Options and Compliance Simplifications That Ease Financial and Administrative Burdens

Phased retirees represent a unique category of workers. Even though most workers currently do not stay with a single employer for a significant period of time, a short employment period is almost guaranteed for a phased retiree. Therefore, employers may be hesitant to take on the administrative and financial burdens associated with a defined benefit plan. However, there are defined benefit plan options that may eliminate these burdens for certain employers. In addition, statutory and regulatory changes aimed at simplifying employee benefit administration may also ease these burdens.

[40] 26 U.S.C. section 401(h)(1).
[41] 26 U.S.C. section 420(b)(5).

A. Multiemployer and Multiple Employer Programs

One method of decreasing costs and administration is to split the burden with other employers. Multiemployer and multiple employer plans are structured specifically to maximize portability among defined benefit plans. To the extent these structures are available to an employer, they can increase the benefit that a worker can accumulate and reduce the cost and administration usually associated with a single-employer plan.

A multiemployer plan consists of two or more employers and is maintained by a collective bargaining agreement.[42] An employee who participates in a multiemployer plan continues to accrue benefits as long as the employee works for an employer who belongs to the plan.[43]

A multiple employer plan consists of two or more employers, but a collective bargaining agreement is not required. Generally, the employers are in related businesses. Therefore, a multiple employer defined benefit plan represents a viable option for businesses and industries that are not unionized. Similar to a multiemployer plan, a participant accrues benefits under the plan as long as he or she works for an employer under the plan.[44]

For employers, these options are attractive not only because costs are shared among employers, but also because costs are spread over the lives of numerous employees. Under any defined benefit plan, employers make contributions on behalf of all employees. The advantage of the defined benefit plan is that retirement costs are amortized over the working lives of employees. Therefore, the more employees, the more that costs can be amortized. Moreover, the costs of amortization are divided among several employers. Therefore, multiemployer and multiple employer plans are viable options in providing a defined benefit plan to phased retirees.

B. Cash Balance Plans

Another method of funding a defined benefit plan for phased retirees is to use a cash balance benefit plan, in which the advantages apply equally to all retirees and potential retirees. However, an employer who wants to implement a

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[42] 26 U.S.C. section 414(f); ERISA section 3(37).
[43] 26 U.S.C. section 411(a)(4); ERISA section 210.
[44] 26 U.S.C. section 411(a)(4); ERISA section 210.

defined benefit plan to attract or retain phased retirees may prefer to establish a cash balance plan because it redistributes retirement funds more evenly across all eligible participants, and the cash balance concept is easier for many employees to understand.[45]

Cash balance plans have garnered a lot of attention recently due to disputes over whether they comply with the ADEA.[46] The ADEA issues primarily concern the conversion of traditional final average pay plans to cash balance plans. The IRS is permitting the establishment of new cash balance plans. Therefore, an employer who offers only a defined contribution plan can establish a cash balance plan with little risk of generating charges of violating the ADEA.

The cash balance plan design, which legally is considered to be a defined benefit plan, attempts to capture some of the advantages of defined contribution plans, such as 401(k) plans, while retaining many of the advantages of traditional defined benefit plans. As with a defined contribution plan, benefits are regularly expressed in terms of an account balance, even though the individual accounts are usually fictional.

Like a defined contribution plan, benefits in a cash balance plan are expressed in terms of a current value—the account balance—that will grow with periodic benefit and interest credits, thus making it easy for employees to know exactly what their benefits are worth at any time and how they will grow in the future.

And, like a defined contribution plan, meaningful benefit values are earned throughout an employee's career as compared to the benefit values in a traditional defined benefit plan that tend to be minimal at the younger ages and then grow rapidly upon reaching retirement eligibility.[47]

Like a traditional defined benefit plan, cash balance plans do not require employees to contribute in order to receive any employer-provided benefits. Since a cash balance plan is treated as a defined benefit plan, benefits are funded

[45] United States General Accounting Plans – Implications For Retirement Income (GAO/HEHS-00-207, September 2000).
[46] *Eaton v. Onan Corporation*, No. 1P97-814-C H/G (S.D. Ind. Sept. 29, 2000) (the court ruled that cash balance plans are not inherently age discriminatory but deferred the question of whether transition provisions create backloading).
[47] *Cash Balance Plans Best of Both Worlds,* Plan Sponsor, April 1999.

in the aggregate — the sum of the employees' account balances at any time does not have to equal the amount of assets in the trust, as in a defined contribution plan.

The result is that there is often a range of allowable contributions available to the employer, and when the plan is very well funded (e.g., assets are more than account balances), the employer can credit account-like benefits without having to come up with current cash as would be required in a defined contribution plan. Also like traditional pension plans, cash balance programs place the investment risk with plan sponsors, instead of plan participants. Cash balance plans also retain the same investment efficiency and benefit design flexibility as any traditional defined benefit plan.[48]

A cash balance plan has an advantage over the traditional pension plan in that it does not encourage premature retirement. A participant who continues to work after normal retirement age in a traditional pension plan must forfeit further accruals and early retirement subsidies. Under a cash balance plan, rather than being "encouraged" to retire prematurely, some older employees will be able to retain their jobs and more than make up for any reduction in pension through additional pension accruals and personal savings.[49] This feature is especially important to a phased retiree who wants to continue accruing benefits while employed. Thus, for all of the reasons above, a cash balance plan is a useful tool in attracting and retaining phased retirees.

C. Easing Administrative and Financial Burdens of Defined Benefit Plans by Simplifying Compliance Requirements

A Joint Committee on Taxation report states that "federal laws and regulations governing employer-provided retirement benefits are among the most complex set of rules applicable to any area of the tax law."[50] Also, "this complexity deters employers from establishing qualified retirement plans or forces the termination of such plans."[51] Congress and the Internal Revenue Service ("IRS") have already taken steps to simplify the administrative

[48] *Cash Balance Plans: Best of Both Worlds*, Plan sponsor, April 1999 <http://www.assetpub.com/psapril99/april99PS024_right.html>.
[49] *Cash Balance Plans: Best of Both Worlds*, Plan sponsor, April 1999 <http://www.assetpub.com/psapril99/april99PS024_right.html>.
[50] joint committee on taxation, study of the overall state of the federal tax system and recommendations for simplification (Volume II, April 2001).
[51] joint committee on taxation, study of the overall state of the federal tax system and recommendations for simplification (Volume II, April 2001).

complexity associated with benefit plans in general and defined benefit plans in particular.

1. Changes to Funding of Defined Benefit Plans

Section 404 of the Internal Revenue Code limits the amount of contributions that an employer may make to a defined benefit plan. For the past decade, the returns on stock investments have eliminated the need for many employers to contribute to retirement plans because the returns on investment caused plans to reach maximum funding limitations without employer contributions. The recent decline in the stock market has now created the need for significant employer contributions. Therefore, in a time of economic surplus, employers received no benefit by contributing to retirement plans and, in a time of economic decline, employers are being penalized for not contributing to retirement plans. This is backwards in that employers cannot make contributions when assets are available, but must make contributions when assets are less readily available. Rather than discouraging employers from making pension contributions when assets are available, the government should encourage such contributions.

To avoid risking further pension assets, a rule could be implemented to allow contributions in excess of the full funding limit if such contriubutions are maintained in a guaranteed interest account. Thus, the excess contributions would not be subject to investment risk and would available to participants even in periods of economic decline. Also, it might prevent the employer from having to reduce benefits during an economic downturn.

In addition, the funding of defined benefit plans are tied to 30-year Treasury bond rates. Due to the government buyback and subsequent discontinuance of 30-year Treasury bonds, rates for the long-term debt instrument are no longer a stable or appropriate benchmark for plan funding. As a result, required contributions to pension plans have skyrocketed even though plans are well funded for their liabilities. Representatives Rob Portman (R-OH) and Ben Cardin (D-MD) have indicated that they will introduce legislation temporarily correcting this problem.[52] Presumably, positive response to a temporary measure would lead to permanent reform.

2. Proposed Legislation to Combine Defined Benefit and Defined Contribution Features

Rep. Rob Portman and Rep. Ben Cardin are also considering the concept of a plan with the features of a combined benefit and defined contribution plan. Several proposals are currently being considered. [53]

Under one proposal, the employer sets up a single trust for both defined benefit and defined contribution contributions. There would be unallocated employer money to fund defined benefit pensions. Separate from that—but inside the trust—would be allocated accounts for individual employees to use in making 401(k) investment, which would be pre-tax money.

Another proposal keeps 401(k) plans as they are now but instead of having an employer matching funds to supplement a participant's balance, it would use the match money for a supplemental defined benefit pension.

Combining DB and DC in the same plan could cut administrative costs. Also, it may provide greater stability and increased resources for all retirees. Even though these proposals are only in the beginning stages, they warrant further consideration. Combining the flexibility of a defined benefit plan with the predictability and stability of a defined contribution plan could satisfy both employers and employees.

[52] Press Release, THE ERISA INDUSTRY COMMITTEE, Portman and Cardin to Introduce Pension Funding Bill (January 23, 2002).

[53] Stan Wilson, *Portman-Cardin II Pension Reforms Could Put DB and DC Plans Together,* defined contribution news, January 13, 2002 < http://www.dcnews.com/top+news/pension+reforms+could+put+db+and+dc+plans+together.asp >

3. Minimum Distribution Rules

The minimum distribution requirement is widely viewed as one of the most complex set of rules affecting tax-favored retirement plans. In general, the distribution of minimum benefits must begin no later than the required beginning date.[54] Failure to comply with the minimum distribution rules results in an excise tax imposed on the participant equal to 50% of the required minimum distribution not distributed for the year.[55]

On January 11, 2001, the IRS issued proposed changes to simplify the minimum required distribution regulations.[56] The proposed regulations introduced a uniform distribution period based upon the joint life expectancies of a participant and a survivor ten years younger. The table is to be used by all participants, unless the participant's sole beneficiary is a spouse and the spouse is more than 10 years younger than the participant. In that case, the participant is permitted to use the longer distribution period measured by the joint life expectancies of the participant and spouse. In addition to simplifying administration, the proposed regulations are intended to reduce the amount of the minimum required distribution for a large number of participants, because, under the distribution table, all beneficiaries are considered to be ten years younger than the participant, regardless of any beneficiary's actual age.

Since information about the designated beneficiary is not necessary to calculate the minimum required distribution, the proposed regulations permit the designated beneficiary to be determined as late as the end of the year following the year of the participant's death, rather than at the participant's required beginning date. Therefore, a participant may change beneficiaries after the required beginning date without requiring a recalculation of the minimum required distribution. Moreover, if a beneficiary who is designated at the time the distribution begins later disclaims or cashes out of the benefit, the participant's minimum required distribution remains unaffected. Consequently, one of the most complex administrative rules has been simplified and should be easier for both employer and employee to follow.

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[54] 26 U.S.C. section 401(a)(9).
[55] 26 U.S.C. Section 4974.
[56] Required Distributions from Qualified Plans and Individual Retirement Plans Notice of Proposed Rulemaking, 52 Fed. Reg. 28070 (2001) (to be codified at 26 C.F.R. section 1.401(a)(9) (proposed Jan. 11, 2001).

4. Simplification of the Determination Letter Application Process

In Announcement 2001-77, the IRS announced a simplification plan for the process of submitting determination letter applications. These changes will give plan sponsors the flexibility to request a determination letter that considers either the form of the plan only or both the form of the plan and compliance with the requirements of Code sections 401(a)(4), 401(a)(26) and 410(b).

Plans must still comply with these requirements; however, proof of compliance will not be required. If a form-only letter is requested, Schedule Q is no longer required.[57] Simplifying this process eases the administrative burden on plan sponsors who want to receive a determination letter.

The IRS announcement also encourages practitioners to highlight the changes to plans that have previously received favorable determination letters. This will hopefully curb questions concerning provisions that have previously received determination letters.[58]

In addition, the IRS is engaged in an ongoing study of the future of the Employee Plans determination letter program and expects to publish a report of this study in the near future.[59] Therefore, further changes and, hopefully, simplification may follow.

5. Elimination of the Combined 415(e) Limit

On August 20, 1996, the Small Business Job Protection Act of 1996 was enacted. The Act includes a provision eliminating the combined limit under Code section 415(e), a complex set of limits that applies to a participant who is covered by both a defined benefit and a defined contribution plan sponsored by the same employer. Since almost all but the smallest plans have provided for the pension (rather than the defined contribution account) to be reduced if the combined benefits go over the Code section 415(e) limit, the administrative impact of eliminating that limit is greatest for defined benefit plans in that participants who were

[57] IRS Announcement 2001-77.
[58] *What's New,* TRI Pension Services <http://www.cyberisa.com/erisa_new.htm>.
[59] IRS Announcement 2001-77.

exceeding the combined limit can now receive a greater pension benefit. The repeal of the combined limit also reduces the amount of administrative compliance by eliminating a compliance test.

6. Elimination of Prohibited Employment

Despite the simplifications that have occurred, another compliance requirement should be addressed. In general, ERISA protects a participant's right to his accrued benefit.[60] One exception to this rule is if a participant continues to work for the employer who sponsors the plan.[61] An employer may suspend benefits that commence prior to normal retirement age, exceed the normal retirement benefit, or both.[62]

The rule encourages unnecessary shifts in employment. Whereas an employee may consider moving from full-time to part-time work with the same employer, the suspension of certain accrued benefits may encourage the employee to switch employers as well. As a result, the employer loses a skilled worker and the employee must expend time and energy finding another job and then retraining in the new job. In the case of multiemployer and multiple employer plan participants, the potential suspension may encourage employees to abandon their area of expertise altogether.

The Department of Labor ("DOL") regulations do limit the effect of the rule somewhat by applying it only if the participant works more than 40 hours in a month.[63] However, this number does not exclude many people. In a DOL report, only 8.5% of persons age 55 and older who were employed in 1998 worked less than 15 hours a week.[64] Therefore, less than 8.5% of retirement age workers would be excluded from the suspension rule.

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[60] ERISA Section 203(a).
[61] ERISA Section 203(a)(3)(B)(i). In the case of a participant under a multiemployer plan, the result is even more extreme because he or she may forfeit benefit payments after retirement if he or she is employed in the same trade or craft, and in the same geographic area covered by the plan.
[62] 29 C.F.R. Section 2530.203-3(a).
[63] 29 C.F.R. Section 2530.203-3(c).
[64] U.S. Dept of Labor, Report on the American Workforce (1999).

If defined benefit plans are intended to benefit phased retirees, this requirement should be amended. Rather than discouraging continued employment in this manner, Congress should amend the statute to eliminate the suspension rule. At the very least, the statute should be amended to truly exclude part-time workers. Persons who work less than 100 hours in one month (25 hours a week) should be exempted from the rule. Thereby, phased retirees who continue to work beyond retirement age would remain entitled to the full value of their retirement benefits.

VI. Conclusion

The defined benefit plan is an old solution to new concerns. With a large portion of the workforce approaching retirement age, employers must consider methods of retaining and attracting workers. In response to retirees opting for alternative retirement scenarios that include phased retirement, a defined benefit plan could be a valuable tool. Increased life expectancy, rising medical cost, and the uncertainty of the Social Security system contribute to greater financial needs during retirement.

The ability to continue earning pension credit while scaling back on working hours is an attractive option to many retirees. Moreover current and future simplifications may ease the administrative burdens and costs on employers that are associated with defined benefit plans. After a decade predominated by defined contribution plans, it may be time for employers to reconsider defined benefit plan options as a tool for retaining and attracting valuable workers.