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WORKING AFTER NORMAL RETIREMENT AGE: PENSION ACCRUALS FOR POST-65 SERVICE

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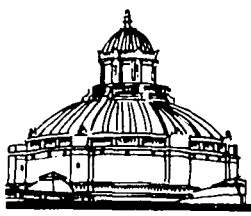

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WORKING AFTER NORMAL RETIREMENT AGE: PENSION ACCRUALS FOR POST-65 SERVICE

SUMMARY

Prior to 1988, company pension plans did not have to provide pension credit for employees continuing work after age 65. Older workers could also be excluded from a defined benefit pension plan if they were hired within 5 years of normal retirement age. While most workers retired by age 65, the absence of pension accruals was costly to those who did not. Passage of the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509) (OBRA) changed this situation. Pension plans are now generally required to provide benefit accruals for service after age 65. The amendments apply to pension plan years beginning on or after January 1, 1988, but only to employees who have performed at least one hour of service in any plan year to which the amendments apply. (Pension plans often operate on a fiscal year rather than on a plan year basis. Hence, the term "plan year.") Even though pension plans are now required to credit service after normal retirement age, they still are permitted under the law to have an overall cap on benefits (such as 50 percent of pay) or maximum years of service that will be counted (such as 30 years).

The OBRA '86 amended provisions of the Age Discrimination in Employment Act (ADEA), the Employee Retirement Income Security Act (ERISA), and the Internal Revenue Code. The amendments direct the Treasury Department, the Labor Department, and the Equal Employment Opportunity Commission (EEOC) to issue rulings and regulations that are consistent. They also instruct the agencies to consult with one another in issuing such rulings and regulations. The Treasury Department has primary jurisdiction over the benefit accrual requirements addressed in the OBRA '86 legislation. At issue is a proposed IRS regulation that would make pension credit retroactive to cover prior service between age 65 and the law's effective date. Many observers contend that OBRA '86 provisions do not require retroactive credit. Since most workers choose to retire at or before age 65, a requirement that employers provide pension credit to older workers for service before 1988 would not be expected to significantly increase pension costs.

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WORKING AFTER NORMAL RETIREMENT AGE: PENSION ACCRUALS FOR POST-65 SERVICE

I. BACKGROUND

The Omnibus Budget Reconciliation Act of 1986 (OBRA '86) amended the Age Discrimination in Employment Act of 1967 (ADEA), the Internal Revenue Code of 1986 (Tax Code), and the Employee Retirement Income Security Act of 1974 (ERISA) to require employer-sponsored retirement plans to grant pension credit for work performed after reaching normal retirement age. 1/ Effective January 1, 1988, pension plans are generally required to provide benefit accruals for service after age 65. At issue is a proposed Internal Revenue Service (IRS) regulation that would make pension credit retroactive to cover prior service between age 65 and the law's effective date.

Before the OBRA '86 amendments, company pension plans did not have to provide pension credit for employees continuing to work after age 65. 2/ Older

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1/ Subtitle C (Older Americans Pension Benefits) of Title IX of the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509)(100 Stat. 1874, 1973).

2/ The Department of Labor was initially responsible for administering and interpreting the age discrimination law. Under an Interpretive Bulletin issued by the Department of Labor in 1978, employers were allowed to cease contributions and accruals to pension plans for employees who continued to work beyond normal retirement age. When the Equal Employment Opportunity Commission (EEOC) assumed responsibility for the Age Discrimination in Employment Act in 1979, it stated that the Labor Department's Interpretive Bulletin would remain in effect pending review. Subsequently, the EEOC stated its intent to prohibit the cessation of contributions and accruals to pension plans on account of age and was prepared to vote at its Nov. 10, 1986 meeting regarding publication of the proposed rules. In the meantime, Congress passed

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workers could also be excluded from a defined benefit plan if they were hired within 5 years of the normal retirement age. The absence of pension accruals was costly to many older workers. The Employee Benefit Research Institute (EBRI) estimated that an employee who delayed retirement by 5 years could lose up to half the value of benefits accrued at age 65. 3/ About 58 percent of private sector workers were in plans freezing pension benefits at age 65. Even so, a significant number of plans did provide some or full pension credit for service after age 65--particularly very large employers. Some companies adjusted benefits upward actuarially because of the shorter payout period; more often, companies increased benefits by taking into account salary and/or service earned after age 65. 4/ However, a significant number of workers received no pension credit for delaying retirement. 5/ This all changed with OBRA '86.

(continued) OBRA '86 on Oct. 17, 1986, to require pension credit for post-65 service. However, because of a court order entered on Feb. 26, 1987, by Judge Harold Greene in the American Association of Retired Persons v. the Equal Employment Opportunity Commission (Civil Action no. 86-1740, United States District Court for the District of Columbia), EEOC's proposed rule relating to the cessation of contributions and accruals was published on Apr. 2, 1987 (52 FR 10584). On July 20, 1988, EEOC published notice of its withdrawal of the proposed rule (53 FR 27360). Among the reasons cited were the OBRA '86 amendments setting a 1988 or later implementation date, the need for EEOC to develop OBRA '86 rules, and the burden on employers to amend their plans twice within a 1- or 2-year period.

3/ Employee Benefit Research Institute. Pension Accruals for Older Workers. Issue Brief Number 35, Washington, Oct. 1984.

4/ U.S. Congress. House. Committee on Post Office and Civil Service. Designing a Retirement System for Federal Workers Covered by Social Security. Committee Print No. 98-17, prepared by the Congressional Research Service. Washington, U.S. Govt. Print. Off., Dec. 1984.

5/ In the study Cost of Mandating Pension Accruals for Employees Age 65-69 prepared by William M. Mercer-Meidinger, Inc., for the American Association of Retired Persons in Oct. 1985, it was estimated that the total annual value of pension benefits lost because employers did not grant full pension credit to those employees working beyond age 65 was approximately $450 million. If there was no increase in the number of employees over age 65 and pension plans continued to provide contributions and crediting of service, it was estimated that giving pension accruals to older workers would increase employer cost in the first year by $51.5 million, which was less than 1/10 of 1 percent of total U.S. pension costs.

Effective January 1, 1988, pension plans are required to provide benefit accruals for service after normal retirement age (i.e., age 65). In addition, companies may not exclude older workers hired within 5 years of normal retirement age from participating in the retirement plan. The 1986 budget reconciliation measure also abolished mandatory retirement effective January 1, 1987. However, there are certain exceptions:

- o High-paid executives with pensions of at least $44,000 annually can still be forced to retire at age 65.
- o Police and firefighters can be forced to retire under State laws until 1993 (subject to a joint Department of Labor/Equal Employment Opportunity Commission study of the possibility of using physical and mental fitness tests).
- o Tenured faculty could be forced to retire at age 70 (subject to a National Academy of Science study of the potential consequences of the elimination of mandatory retirement on colleges and universities).

II. SUMMARY OF PROPOSED IRS REGULATIONS

The OBRA '86 calls for the Secretary of Labor, Secretary of the Treasury, and the Equal Employment Opportunity Commission (EEOC) to issue rulings and regulations that are consistent and to consult with each other in issuing such rulings and regulations. The OBRA '86 conferees said they intended that the provisions of ADEA, ERISA and the tax code regarding benefit accruals for older workers "be interpreted in a consistent manner." IRS was given lead regulatory authority. 6/

A. Defined Benefit Plans

Under proposed IRS regulations (see Federal Register, April 11, 1988), defined benefit pension plans would be generally required to provide benefit accruals and vesting credit for all service after normal retirement age. 7/ To be entitled to this post-65 pension credit, the worker must have at least 1

6/ The Treasury Department was authorized by the OBRA '86 conferees to issue regulations coordinating the continuing benefit accrual requirements with other requirements of the tax code, ERISA, and ADEA. Congressional Record, Oct. 17, 1986. p. H11423. Under Reorganization Plan no. 4., implemented in 1978, authority to issue regulations and rulings concerning funding, participation, and vesting of benefit rights (including benefit accruals) was transferred to the Secretary of the Treasury from the Secretary of Labor.

7/ A defined benefit plan specifies the benefit payable upon retirement such as 1 percent of average pay for each year of service.

hour of service in the first plan year beginning on or after January 1, 1988. 8/ There is a later effective date for collectively bargained plans. 9/ Moreover, retroactive accruals and vesting credit would have to be granted for a participant's service and compensation after normal retirement age, but before plan years beginning in 1988.

For example, assume that an individual age 70 is still working in 1988 for a company that ceased providing pension credit upon his reaching age 65. The plan operates on a July 1-June 30 fiscal year basis. Effective July 1, 1988, the participant would receive retroactive service credit for the 5 years of service since 1983. (However, if an older employee had been excluded from participating in the plan because he had been hired within 5 years of normal retirement age, the proposed regulations would require that the individual be given retroactive service credit for vesting purposes only.)

Notwithstanding the requirements for granting pension credit for service performed after normal retirement age, pension plans would still be permitted to:

- o have an overall cap on benefits (such as 50 percent of pay) or maximum years of service that will be counted (such as 30 years). 10/

8/ Pension plans often operate on a fiscal year rather than a calendar year basis. Hence the term "plan year."

9/ For employees covered by a collective bargaining agreement that was ratified before Mar. 1, 1986 and that is still in effect (without regard to any extension made after Feb. 28, 1986), the effective date would be the earlier of the first plan year after the agreement terminates or the first plan year in 1990.

10/ Any limits on benefit accruals or years of service could not in any way be based on age. However, a plan could provide different benefit accrual rates provided that they are not based on age and are consistent with ERISA; for example, 1-1/2 percent of final average pay for the first 20 years of service and 1 percent thereafter.

- o stop pension benefit accruals at normal retirement age if plan provides an "actuarial adjustment" to the benefits paid to workers who defer retirement.
- o disregard the subsidized portion of an early retirement benefit or a social security supplemental benefit in determining benefit accruals.

B. Defined Contribution Plans

For a defined contribution plan, employer contributions (or allocation of forfeitures) could not be discontinued or decreased because of the attainment of any age. However, the plan could limit the total amount of employer contributions that may be allocated to a participant's account as well as the total number of years of service for which contributions are made. 11/

The IRS regulations would not require that retroactive contributions be made to defined contribution plans for plan years before January 1, 1988 (or later for certain collective bargaining employees), for periods of service after normal retirement age, but before the effective date of the OBRA '86 requirements. However, credit would have to be granted for all service occurring after normal retirement age in determining vesting credit and entitlement under any service-related allocation formula of gains, losses, or income of the trust fund to the account of a participant.

C. All Plans

Neither an allocation to the account of a participant in a defined contribution plan, nor an accrual under a defined benefit plan, is required if it would cause the contribution or benefit to exceed the limits specified in

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11/ Provided that the limitation is not based, directly or indirectly, on the attainment of any age.

section 415 of the tax code. This same exception holds if it would cause the plan to discriminate in favor of highly compensated employees within the meaning of section 401(a)(4) of the tax code.

The proposed regulations also require that optional forms of benefits after a specified age (such as a lump sum, or any ancillary benefits, rights, or features) be at least as favorable to employees as benefits before such age.

D. Employee Contributory Plans

Under the proposed IRS regulations, a defined benefit or a defined contribution plan (including a 401(k) arrangement) would not violate the age discrimination law merely because the participant was not eligible to make mandatory or voluntary contributions to a contributory plan for a plan year after attainment of normal retirement age, but before the effective date of the OBRA '86 requirements. If the plan did not permit a participant to make these contributions after reaching normal retirement age, it would not be required to grant benefit accruals for those years in which the participant made no contributions. Also, the plan would not be required to permit the participant to make up the employee contributions in order to qualify for benefit accruals for those years.

III. RETROACTIVITY ISSUE

Before the IRS issued the proposed benefit accrual regulations, many employers had already decided to provide retroactive credit in their defined benefit plans. Still others had already provided for such credit before the OBRA '86 amendments. Many observers contend that the OBRA '86 changes do not require retroactive credit. They base their argument on the provision in the law which states that the amendments with regard to benefit accruals "shall apply only with respect to plan years beginning on or after January 1, 1988, and only to employees who have 1 hour of service in any plan year to which such amendments apply." In this regard, they point to proposed rules published earlier by the EEOC on November 17, 1987, which state that the benefit accrual provisions "are not applicable to an employee for any plan year beginning before January 1, 1988, **even if the employee is credited with at least one hour of service in a plan year beginning on or after January 1, 1988.** (Emphasis added)." It is reported that the EEOC position was based, in part, on a legislative compromise worked out calling for nonretroactivity as a way of assuring passage. 12/

Since the IRS has primary responsibility for interpreting the continuing benefit accrual requirements of the new law, the EEOC will likely be forced to follow suit despite its earlier position. Since most workers choose to retire at or before age 65, requiring employers to provide pension credit for service before 1988 would not be expected to significantly increase plan costs. The

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12/ IRS Preempts EEOC; Seeks Retroactivity for Post-65 Pension Accruals. The Compensation and Benefits File, v. 4, no. 3, the Wyatt Company, Mar. 1988.

IRS held a hearing on August 22, 1988, to receive comments on the proposed regulations.