HOW FEDERAL PENSION LAWS INFLUENCE INDIVIDUAL WORK AND RETIREMENT DECISIONS

Jonathan Barry Forman*

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*Professor of Law, The University of Oklahoma College of Law; Northwestern University, B.A., 1973; University of Iowa, M.A. (Psychology), 1975; University of Michigan, J.D., 1978; George Washington University, M.A. (Economics), 1983. Delegate to the 1998 National Summit on Retirement Savings. The author wishes to thank Patricia L. Scahill, Kathryn L. Moore, and Beverly J. Orth for their comments on earlier drafts.
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INTRODUCTION

Millions of Americans retire while they are still productive. Of those, many will have the resources to enjoy all of their golden years. Unfortunately, many others will face economic hardships if they exhaust their resources after they have become too frail to return to work. The current pension system is fraught with financial incentives that push able-bodied elderly workers into retirement just when instead they should be encouraged to remain in the work force to accumulate additional retirement assets. This article considers how federal pension laws should be changed in order to encourage elderly workers to remain in the work force.1

Part I of this article provides some background on the aging of America and its implications for retirement policy. Part II explains how specific provisions of the federal Employee Retirement Income Security Act of 1974 (ERISA)2 and related provisions of the Internal Revenue Code influence the work and retirement decisions of older Americans. Part III considers the appropriate role of the government in regulating the pension system as it affects the timing of retire-

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ment. Finally, Part IV recommends modifications to ERISA and the Internal Revenue Code in order to encourage elderly workers to remain in the work force.

I. HOW PENSION POLICY INFLUENCES THE TIMING OF RETIREMENT

A. Nontechnical Overview of the Problem

America’s work force is aging, and this demographic change will have a major impact on our economy in the twenty-first century. In just thirty years, an unprecedented twenty percent of the U.S. population will be age sixty-five or older, up from just twelve percent today. Just look at Florida, the nation’s retirement state. By 2025, thirty-nine states will have at least the same share of elderly as Florida has today. In short, the United States is becoming a nation of Floridas.

Demographers blame longer life expectancies and lower birth rates for the graying of America. In particular, Americans are living longer and healthier lives. For example, the life expectancy for a sixty-five-year-old man has increased from twelve additional years in 1940 to sixteen additional years today. For women, these additional years have grown from thirteen to nineteen.

At the same time, however, Americans are retiring earlier and earlier. Today the average American retires at age sixty-two, compared with age sixty-five only thirty years ago. Older men leaving the work force today can anticipate eighteen years of retirement, up from only thirteen years just thirty years ago.

Of course, it is great that people are living longer and healthier lives, and it is wonderful that most of us can look forward to decades of retirement. However, it appears doubtful that either individuals or the nation can continue to afford ever-longer retirements. In 1950, working-age people outnumbered the elderly seven to one. By 2030, when the last baby boomers reach age sixty-six, this ratio will shrink to less than three-to-one. With fewer workers relative to retirees, younger generations will confront increasing burdens to support the elderly. Social Security and Medicare already face financial trouble, and they will be all but bankrupt in thirty years. Medicaid, Supplemental Security Income, food stamps, and the private pension system will also be stretched to their limits. Meanwhile, the rate of economic growth will fall significantly.


Committee For Economic Development, supra note 3, at 5. See the discussion at page 157.

Id., at 6.

Id., at 2.


Committee For Economic Development, supra note 3, at 11.
Much of the solution to these economic problems hinges on extending the working lives of Americans. To make this happen, employers need to change their attitudes and policies, and the federal government needs to get rid of the archaic work disincentives in its Social Security, Medicare, and pension laws. Moreover, changes need to be made soon, before the bulk of the baby boomers retire.

In particular, the private pension system must correct its financial incentives. At present, many traditional private pension plans penalize work after early retirement ages, which often occur as low as age fifty-five. Federal pension laws should be revised so that private pension plans can no longer assess penalties for work performed by older Americans. Current federal pension and benefit laws should also be amended to allow greater flexibility in the hiring and retention of older workers, especially for contingent and part-time work.

B. The Impact of Private Pensions on the Timing of Retirement

Private pension plans can have a significant impact on the timing of retirement. First, along with Social Security and other public benefits, private pensions help provide additional income and wealth needed for retirement. Second, by design, many pension plans produce financial incentives that encourage early retirement.

1. The Income (Wealth) Effect of Pensions

The decline in the average age of retirement may be attributed to the increasing income and wealth of American families. Along with Social Security and Medicare, pensions provide a large portion of the income (wealth) that enables elderly Americans to choose retirement over work. In short, pensions help provide Americans with the income they need for retirement.

From 1962 to 1995, for example, the average net worth of American families increased from $114,000 to $206,000. A large part of that increase in net worth may be attributed to the rapid expansion of private pension systems after World War II. Indeed, one study estimated that the growth of pensions could account for as much as one-fourth of the decline in labor force participation in the early postwar period. Similarly, numerous studies have found that workers with access to pension income are more likely to retire than workers without such coverage.

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11 COMMITTEE FOR ECONOMIC DEVELOPMENT, supra note 3, at 6.


Moreover, this income or wealth effect creates an impact on people at all income levels. In particular, generous Social Security benefits and the health security provided by Medicare and Medicaid have made early retirement possible for virtually all Americans. Many analysts believe that the availability of full Social Security benefits at age sixty-five and the availability of reduced benefits at age sixty-two have greatly contributed to the trend toward earlier retirement.

The income (wealth) effect of private pensions probably affects the upper half of the income scale the most. Pension plans cover only about sixty percent of workers aged forty to sixty. Moreover, pensions accounted for a mere three percent of the retirement income of the lowest quintile of elderly Americans in 1996 and for just seven percent of the income of the second lowest quintile. On the other hand, pensions accounted for twenty-four and twenty-one percent for the income of the top two quintiles.

2. An Overview of the Financial Incentives Created by Pensions

Pension plan designs can create powerful financial incentives that influence individual work and retirement decisions. In particular, traditional defined benefit plans create financial incentives that induce most workers to retire during windows of opportunity that range from the early retirement age through the normal retirement age. First, traditional defined benefit plans provide large financial incentives for workers to stay with their employers until they become eligible for early retirement. Second, traditional defined benefit plans typically impose large financial penalties on workers who stay past the plan’s normal retirement age. Moreover, many plans provide early retirement incentives that push older workers out of the work force at even earlier ages. Defined contribution plans...
can also influence the timing of the decision to retire, but their effects are typically less dramatic.\footnote{Richard A. Ippolito, Pension Plans and Employee Performance, 10-17 (1997).}

3. \textit{Traditional Defined Benefit Plans Are Backloaded}

Pension benefits typically accrue differently under defined benefit plans and defined contribution plans. In particular, under a traditional defined benefit plan, benefit accruals increase significantly the closer a worker gets to retirement. For example, a typical “final average pay” plan might provide that a worker’s annual retirement benefit equals two percent times years of service times final average compensation. Under this formula, a typical worker with thirty years of service would receive an annual retirement benefit equal to sixty percent of her pre-retirement earnings (sixty percent equals two percent times thirty). Final average pay typically derives from averaging the worker’s salary over the three or five years immediately prior to retirement.\footnote{See Sharyn Campbell, Hybrid Retirement Plans: The Retirement Income System Continues to Evolve, Employee Benefit Research Inst. Special Report No. 32 & Issue Brief No. 171 (1996); Kelly Olsen & Jack VanDerhei, Defined Contribution Plan Dominance Grows Across Sectors & Employers Sizes, While Mega Defined Benefit Plans Remain Strong: Where We Are & Where We Are Going 27-29 Employee Benefit Research Inst. Special Report No. 33 & Issue Brief No. 190 (1997).}

Final average pay plans are backloaded, meaning that they tend to favor disproportionately older workers who have stayed with an employer for twenty-five or thirty years. This backloading occurs primarily because the value of benefit accruals typically increases as a percentage of pay as workers approach retirement age.\footnote{See, e.g., Jonathan Barry Forman & Amy Nixon, Cash Balance Pension Plan Conversions, 25 (Nos. 1 and 2) Okla. City U. L. Rev. 379-434 (2000); Steve J. Kopp & Lawrence J. Sher, A Benefit Value Comparison of a Cash-Balance Plan with a Traditional Final Average Pay Defined Benefit Plan, 11 (No. 1) The Pension Forum 1 (Oct. 1998); Dennis R. Coleman, The Cash Balance Pension Plan 4--FORMAN 143-18403/16/01, 11:00 AM} In fact, well over half of the value of a worker’s pension can accrue in the last five or ten years of service.

On the other hand, benefits accrue at a constant rate under a defined contribution plan. Under a typical defined contribution plan, the employer simply contributes a specified percentage of the worker’s compensation to an individual investment account for the worker. For example, contributions might be set at ten percent of annual compensation. Under such a plan, a worker who earned $30,000 in a given year would receive a $3,000 contribution to her individual investment account. Her benefit at retirement would be based on all such contributions plus the investment earnings on those contributions.

More recently, many companies have been developing so-called hybrid pension plans that mix the features of defined benefit and defined contribution plans.\footnote{See, e.g., Jonathan Barry Forman & Amy Nixon, Cash Balance Pension Plan Conversions, 25 (Nos. 1 and 2) Okla. City U. L. Rev. 379-434 (2000); Steve J. Kopp & Lawrence J. Sher, A Benefit Value Comparison of a Cash-Balance Plan with a Traditional Final Average Pay Defined Benefit Plan, 11 (No. 1) The Pension Forum 1 (Oct. 1998); Dennis R. Coleman, The Cash Balance Pension Plan} For instance, a cash balance plan is a defined benefit plan that looks like a defined contribution plan.\footnote{See, e.g., Jonathan Barry Forman & Amy Nixon, Cash Balance Pension Plan Conversions, 25 (Nos. 1 and 2) Okla. City U. L. Rev. 379-434 (2000); Steve J. Kopp & Lawrence J. Sher, A Benefit Value Comparison of a Cash-Balance Plan with a Traditional Final Average Pay Defined Benefit Plan, 11 (No. 1) The Pension Forum 1 (Oct. 1998); Dennis R. Coleman, The Cash Balance Pension Plan} The plan accumulates a hypothetical account bal-
ance for each participant, with interest. The plan’s benefit formula, which consists of an annual cash balance credit and an interest credit, determines the individual account balances. For example, a simple cash balance plan might allocate six percent of salary to each participant’s cash balance account each year and credit the account with five percent interest on the balance in the account. Like other defined benefit plans, employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. Like defined benefit plans, however, cash balance plans provide workers with individual, albeit hypothetical, accounts.26

In general, traditional defined benefit plans (final average pay plans) provide larger benefit accruals to older workers than typical defined contribution plans or cash balance plans, and they provide smaller benefit accruals for younger workers. On the other hand, defined contribution plans (and cash balance plans) typically provide for more uniform accruals over a worker’s career. Of course, that means that defined contribution plans (and cash balance plans) provide larger benefit accruals than final average pay plans for younger workers and smaller benefit accruals for older workers.

To illustrate, Table 1 provides a comparison between a cash balance plan and a final average pay plan.27 Even though the two plans in Table 1 produce almost identical values at age sixty-five, the cash balance plan offers a more level pattern of accrual throughout the employee’s career, while the final average pay plan is heavily backloaded.

<table>
<thead>
<tr>
<th>Age</th>
<th>Final-Average-Pay Plan</th>
<th>Cash Balance Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>$200</td>
<td>$900</td>
</tr>
<tr>
<td>40</td>
<td>7,200</td>
<td>19,000</td>
</tr>
<tr>
<td>50</td>
<td>42,300</td>
<td>74,700</td>
</tr>
<tr>
<td>60</td>
<td>184,800</td>
<td>212,000</td>
</tr>
<tr>
<td>65</td>
<td>323,200</td>
<td>329,000</td>
</tr>
</tbody>
</table>


26Similarly, a so-called “target benefit plan” is a defined contribution plan that looks like a defined benefit plan. A target benefit plan uses a defined benefit formula to establish a target benefit for each participant. The employer contributions for each participant are actuarially determined to achieve this goal, but this target benefit is not guaranteed. Instead, a worker’s ultimate retirement benefit is based on the actual balance in the worker’s individual account. See CAMPBELL, supra note 24.


28TOWERS PERRIN, supra note 27.

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Similarly, Chart I provides a graphic comparison between a traditional defined benefit plan and a defined contribution plan (or a cash balance plan). Chart I compares the contributions made on behalf of an individual for the following two hypothetical pension plans. The first represents a traditional defined benefit plan that pays a pension benefit at age sixty-five of one percent times years of service times final average pay (a final average pay plan). The second represents a simple defined contribution plan (or a cash balance plan) with a flat contribution rate equal to six percent of salary and interest accruing at the rate of five percent per year.

Chart I shows that the defined contribution plan (or cash balance plan) maintains a fairly level contribution rate at all ages. On the other hand, the traditional defined benefit plan is backloaded, and it imposes severe financial penalties for working past the normal retirement age. In sum, Chart I illustrates that the typical defined contribution plan (or cash balance plan) provides relatively larger contributions than a final average pay plan for younger employees and relatively smaller contributions for older employees.

The differing rates of benefit accrual under traditional defined benefit plans versus typical defined contribution (and cash balance) plans result in different incentives that can affect employee decisions about work and retirement. In particular, traditional defined benefit plans penalize workers who change jobs frequently, create large financial incentives for workers to stay on the job at least until they are eligible for early retirement, and push workers out of the work force once they have reached the plan’s early or normal retirement age.

**CHART I: Annual Contribution Rates (Assuming UC Funding Method and 5 Percent Interest).**

[Diagram of annual contribution rates]

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29See 145 CONG. REC. D1007 (daily ed. Sept. 21, 1999) (chart from testimony of Ron Gebhardsbauer, Senior Pension Fellow, American Academy of Actuaries, before the Senate Committee on Health, Education, Labor, and Pensions); see also Kopp & Sher, supra note 25.

30See Gebhardsbauer, supra note 29.
a. The financial penalty on mobile workers. Table 2 compares the retirement benefits of four workers to demonstrate the magnitude of the financial penalty on mobile workers. These workers all have identical thirty-year pay histories (six percent annual pay increases starting at $20,000 and ending at $108,370), and all their employers have identical final average pay plans (1.5 percent times years of service times final pay). The only difference among these workers is that the first worker spent her entire career with one employer, while the other workers divided their careers over two or more employers. Nevertheless, the long-tenure worker would receive a pension of $49,000 per year at retirement, while the worker who holds five jobs would receive just $27,000 per year.

**TABLE 2: Non-Portability of Final Average Pay Plans**

<table>
<thead>
<tr>
<th>Worker</th>
<th>Employer no.</th>
<th>Yearly accrual rate</th>
<th>Years of service</th>
<th>Final Pay</th>
<th>Total pension</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1</td>
<td>1.5%</td>
<td>30</td>
<td>$108,370</td>
<td>$49,000</td>
</tr>
<tr>
<td>2</td>
<td>1</td>
<td>1.5</td>
<td>15</td>
<td>45,219</td>
<td>10,174</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>1.5</td>
<td>15</td>
<td>108,370</td>
<td>24,383</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>35,000</strong></td>
</tr>
<tr>
<td>3</td>
<td>1</td>
<td>1.5</td>
<td>10</td>
<td>33,791</td>
<td>5,069</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>1.5</td>
<td>10</td>
<td>60,513</td>
<td>9,077</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>1.5</td>
<td>10</td>
<td>108,370</td>
<td>16,256</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>30,000</strong></td>
</tr>
<tr>
<td>4</td>
<td>1</td>
<td>1.5</td>
<td>6</td>
<td>26,765</td>
<td>2,409</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>1.5</td>
<td>6</td>
<td>37,967</td>
<td>3,417</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>1.5</td>
<td>6</td>
<td>53,856</td>
<td>4,847</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>1.5</td>
<td>6</td>
<td>76,396</td>
<td>6,876</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>1.5</td>
<td>6</td>
<td>108,370</td>
<td>9,753</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>27,000</strong></td>
</tr>
</tbody>
</table>

In short, the mobile worker covered by a traditional defined benefit plan will suffer large benefit losses each time she changes jobs. Moreover, even greater

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32 See id.

*Tax Lawyer, Vol. 54, No. 1*
financial penalties can result if a worker changes jobs without vesting. Traditional defined benefit plans penalize workers who change jobs frequently; however, at the same time, these plans create large financial incentives for workers to stay with a single employer at least until they are eligible for early retirement. Critics call this the “golden handcuffs” phenomenon.

b. The financial penalties for staying too long. Final average pay plans also typically push older workers out of the workforce once they reach normal retirement age (usually between ages sixty and sixty-five). Once a worker reaches normal retirement age and becomes eligible to receive full retirement benefits, delaying retirement can actually be quite costly. Those who delay retirement lose current benefits, and the increase in benefits that can result from an additional year of work rarely compensates for the benefits lost. Those who work until they drop may leave nothing behind for their survivors.

Table 3 provides a numerical example of these financial penalties for delaying retirement for a worker under a final average pay plan. Table 3 assumes a worker with thirty years of service could retire at age sixty-five with a $3,000 a year pension. As is common in private sector defined benefit plans, the worker does not receive additional service credit for work after thirty years of service but is permitted to retain the current wage in the pension formula. Moreover, in this simple example, the pension is not actuarially increased for delayed retirement. Consequently, the real value of the pension annuity drops from $45,000 at age sixty-five ($45,000 equals $3,000 times fifteen years from retirement until death at age eighty) to $36,000 if the worker delays retiring until age sixty-eight ($36,000 equals $3,000 times twelve years of retirement). Working until age seventy-two further reduces the value of this pension to just $24,000.

33GUSTMAN & STEINMEIER, supra note 20.
35IPPOLITO, supra note 19, at 146.
36 “Although an employee must continue to accrue benefits after normal retirement age,” an employer does not generally have to “actuarially adjust the benefits to reflect the decreased payout period.” LANGBEIN & WOLK, supra note 31, at 455. Once the worker reaches age 70 1/2, however, the Code now mandates such an adjustment. “Congress modified the law in 1996 by requiring that employees who work past 70 1/2 must have their accrued benefit adjusted to reflect the value of the benefits they would have received if they had retired at age 70 1/2 and had begun receiving benefits at that time.” Id. (citing § 409(4)(9)(c)(iii) and giving examples); see also Prop. Reg. § 1.411(b)-2.
TABLE 3: Implications of “Late” Retirement for Pension Wealth

<table>
<thead>
<tr>
<th>Retirement Age</th>
<th>Present Value of Pension</th>
<th>Percent of Pension Lost from Retiring “Late” (Percent x 100)</th>
<th>Pension Loss as a Percent of Wage (Percent x 100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>65</td>
<td>$45,000</td>
<td>- 0 -</td>
<td>- 0 -</td>
</tr>
<tr>
<td>68</td>
<td>36,000</td>
<td>20.0</td>
<td>90.0</td>
</tr>
<tr>
<td>72</td>
<td>24,000</td>
<td>46.6</td>
<td>210.0</td>
</tr>
</tbody>
</table>

Numerous studies of real world pension plans have found that particular plan designs can result in a significant loss in pension wealth for employees who work past age sixty-five. Moreover, a number of studies suggest that employers can significantly influence the timing of retirement by offering subsidized benefits for workers who elect to retire early. In fact, the structure of private pensions may have a greater influence than Social Security on decisions about the timing of retirement.

Daniel Dulitzky summarizes the features of defined benefit plans that can be used to encourage workers to retire at a particular age as follows:

- Accrual rates that vary with age, earnings, or years of service;
- Wage indexing rules to calculate pensions that vary with age of retirement or years of service;
- Reduction in the normal retirement benefit by retiring early but by less than would be actuarially fair (that is, benefits are reduced but not enough to compensate for the longer period of time they will have to be paid because of early retirement);

37IPPOLITO, supra note 19, at 146.
Assumptions embedded in calculations: pension paid as annuity equal to $3,000 per year; annuity is indexed to inflation; the real rate of interest is zero; normal retirement age is sixty-five; death occurs at age eighty; the wage is $10,000 (real) per year.


• Limit on the increase in pension accrual after a certain number of years in the firm; and
• Explicit buyouts, offered from time to time, to some of the workers in the firm.41

In fact, explicit early retirement incentives commonly occur among firms with traditional defined benefit plans.42 According to one estimate, some eighty percent of Fortune 500 companies have used early retirement incentive plans.43

Moreover, it is not uncommon for employers to design their plans in such a way that benefit accrual rates turn negative at a relatively early age. For example, one recent study of benefit accrual rates of defined benefit plans in 1983 and 1989 found that by the time the workers in their study reached age sixty, the median annual benefit accrual was already close to zero.44 Also, by age sixty-two many of the plans offered normal retirement benefits, and the average benefit accrual rate turned negative. Finally, at age sixty-five, almost all of the plans offered normal retirement benefits, and average benefit accruals became even more negative. This study also found that the average age for early retirement eligibility in these plans fell by about a year, from age 54.2 in 1983 to age 53.1 in 1989.45

Similarly, a recent study by Wharton Professor Olivia Mitchell found that, in 1997, twenty-one percent of participants in the defined benefit plans of medium and large firms were able to retire at age sixty-two with full (unreduced) benefits, up from seventeen percent in 1981.46 Mitchell also found that ninety-five percent of defined benefits plans of medium and large firms in 1997 permitted early retirement.47 Also, sixty-six percent of participants were able to leave by age fifty-five, depending on the circumstances and years of service. In addition, many of these plans provided significant subsidies for early retirement by, for example, providing less than actuarially neutral reductions in benefits.48

In short, “early retirement has been institutionalized.”49 Traditional defined benefit plans inherently provide incentives for workers to retire during windows of retirement opportunity that typically range from the early retirement age through the normal retirement age. Moreover, the trend in recent years has been toward a decline in the normal retirement age and toward increased incentives

41Dulitzky, supra note 40, at 4.
42At the same time, however, little evidence shows why some firms have early retirement incentives and others do not. STUART DORSEY ET AL., PENSIONS AND PRODUCTIVITY 114-15 (1998).
43COMMITTEE FOR ECONOMIC DEVELOPMENT, supra note 3, at 24-25.
45Id., at 9.
47Id., at 11.
48Id., at 11-12, 15.
49Casey, supra note 34, at 20.
4. Defined Contribution Plans (and Cash Balance Plans) Tend to Be Neutral About the Age of Retirement

Defined contribution plans may be designed to influence the timing of a worker’s decision about when to retire, but these plans usually have significantly less impact on those decisions. Defined contribution plans also have large income (wealth) effects. Access to pension income, whether from a defined benefit plan or a defined contribution plan, makes retirement more attractive.

Defined contribution plans typically do not incorporate plan design provisions that are intended to encourage early retirement. Because these plans are not typically backloaded, vested workers do not suffer benefit losses from changing jobs or retiring too early, nor do workers face financial penalties for working past the plans’ normal or earlier retirement ages. The same can be said for cash balance plans.

Defined contribution plans (and cash balance plans) can be designed to influence the timing of retirement. For example, Daniel Dulitzky summarizes the factors related to defined contribution plans that can influence the timing of retirement as follows:

- Employer contribution rates that may change according to age or years of service;
- Early retirement provisions (explicit buyouts);
- Specific tax rules that may affect the timing of retirement (such as penalties for early withdrawal); and
- Potential availability of a lump sum on the condition of leaving the firm.

5. Employers Often Have Economic Incentives to Get Rid of Older Workers

Ultimately, the problem may boil down to the fact that employers often have economic incentives to get rid of older workers. Workers generally cost more to employ as they get older. As a result, the compensation of workers nearing the

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50IPPOLITO, supra note 21, at 10-17.
51Instead, mobile employees can typically roll over their individual account accruals and accumulate large account balances to be used for retirement. This portability provides one of the most important advantages of defined contribution plans, especially for women who typically have shorter job tenures because of greater child and dependent care responsibilities. National Economic Council Interagency Working Group on Security, Women and Retirement Security (1998), available at http://www.pub.whitehouse.gov/WH/Publications/html/Publication.html (last visited Aug. 27, 2000); Teresa Heinz et al., Women’s Institute for a Secure Retirement (WISER), Women and Pensions: An Overview, available at http://www.wiser.heinz.org/pensions_overview.html (last visited Aug. 27, 2000).
52Dulitzky, supra note 40, at 5.
53Committee for Economic Development, supra note 3; Gary Minda, Opportunistic Downsizing of Aging Workers: The 1990s Version of Age and Pension Discrimination in Employment, 48 Hastings L.J. 511, 523-24 (1994); Watson Wyatt, Demographics & Destiny: Winning the War for Talent (1999), available at http://www.watsonwyatt.com (last visited Oct. 10, 2000). As explained in the previous section, the accrual rate for traditional defined benefit plans increases rapidly as workers age. It also costs employers more to provide health insurance coverage for older workers than for
ends of their careers can exceed their productivity.\textsuperscript{54} This creates an economic incentive for employers to avoid hiring or retaining older workers. Employers may even find it advantageous to tap over-funded defined benefit plans or otherwise create early retirement windows to encourage older workers to retire.\textsuperscript{55}

C. Recent Pension and Labor Market Trends

1. The Trend Toward Earlier and Earlier Retirement

As noted above, Americans are living longer and retiring earlier. At the outset, Table 4 shows how life expectancies have increased since 1900. For example, the life expectancy for a male born in 1940 was just 61.4 years; today it is 73.9 years.\textsuperscript{56} Also, a man reaching age sixty-five in 1940 could expect to live another 11.9 years, but a man reaching sixty-five in the year 2000 can expect to live another 15.9 years. Moreover, as the years go by, an increasing percentage of Americans will survive to old age. For example, Table 5 shows that just fifty-four percent of men born in 1875 survived from age twenty-one to age sixty-five in 1940.\textsuperscript{57} On the other hand, eighty percent of men born in 1985 are expected to survive from age twenty-one to age sixty-five in 2050.


\textsuperscript{55}Limiting the definition of compensation that is used to compute benefits can help reduce the cost of retaining older workers. In this regard, Mitchell, supra note 46, at 13, found an increase from 44% to 62% in the fraction of workers in medium and large firms studied who were receiving benefits based on straight-time or base pay alone in the eight years between 1988 and 1995.


TABLE 4: Life Expectancy for Men and Women, 1900-2070\textsuperscript{58}

<table>
<thead>
<tr>
<th>Year</th>
<th>Life Expectancy at Birth</th>
<th>Life Expectancy at Age 65</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Male</td>
<td>Female</td>
</tr>
<tr>
<td>Actual:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1900</td>
<td>46.4</td>
<td>49.0</td>
</tr>
<tr>
<td>1910</td>
<td>50.1</td>
<td>53.6</td>
</tr>
<tr>
<td>1920</td>
<td>54.5</td>
<td>56.3</td>
</tr>
<tr>
<td>1930</td>
<td>58.0</td>
<td>61.3</td>
</tr>
<tr>
<td>1940</td>
<td>61.4</td>
<td>65.7</td>
</tr>
<tr>
<td>1950</td>
<td>65.6</td>
<td>71.1</td>
</tr>
<tr>
<td>1960</td>
<td>66.7</td>
<td>73.2</td>
</tr>
<tr>
<td>1970</td>
<td>67.1</td>
<td>74.9</td>
</tr>
<tr>
<td>1980</td>
<td>69.9</td>
<td>77.5</td>
</tr>
<tr>
<td>1990</td>
<td>71.8</td>
<td>78.9</td>
</tr>
<tr>
<td>Projected:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>73.9</td>
<td>79.6</td>
</tr>
<tr>
<td>2010</td>
<td>75.4</td>
<td>80.4</td>
</tr>
<tr>
<td>2020</td>
<td>76.4</td>
<td>81.1</td>
</tr>
<tr>
<td>2030</td>
<td>77.4</td>
<td>82.0</td>
</tr>
<tr>
<td>2040</td>
<td>78.3</td>
<td>82.7</td>
</tr>
<tr>
<td>2050</td>
<td>79.1</td>
<td>83.5</td>
</tr>
<tr>
<td>2060</td>
<td>79.9</td>
<td>84.1</td>
</tr>
<tr>
<td>2070</td>
<td>80.7</td>
<td>84.8</td>
</tr>
</tbody>
</table>

\textsuperscript{58}2000 Green Book, supra note 56, at 993. The life expectancy for any year represents the average number of years of life remaining for a person if that person was to experience the death rate by age for that year.

*Tax Lawyer, Vol. 54, No. 1*
TABLE 5: Historical and Projected Improvements in Life Expectancy

<table>
<thead>
<tr>
<th>Year Cohort Turns 65</th>
<th>Percentage of Population Surviving from Age 21 to Age 65</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Male</td>
</tr>
<tr>
<td>1940</td>
<td>53.9</td>
</tr>
<tr>
<td>1950</td>
<td>56.2</td>
</tr>
<tr>
<td>1960</td>
<td>60.1</td>
</tr>
<tr>
<td>1970</td>
<td>63.7</td>
</tr>
<tr>
<td>1980</td>
<td>67.8</td>
</tr>
<tr>
<td>1990</td>
<td>72.3</td>
</tr>
<tr>
<td>2000</td>
<td>76</td>
</tr>
<tr>
<td>2010</td>
<td>78.4</td>
</tr>
<tr>
<td>2020</td>
<td>79.3</td>
</tr>
<tr>
<td>2030</td>
<td>80.4</td>
</tr>
<tr>
<td>2040</td>
<td>81.8</td>
</tr>
<tr>
<td>2050</td>
<td>82.7</td>
</tr>
</tbody>
</table>

Despite the fact that life expectancies have increased throughout the century, a trend toward earlier and earlier retirements has emerged. For example, Table 6 shows that the average age at which workers begin receiving their Social Security retirement benefits has fallen from 68.7 years old for workers in 1940 to 63.7 years old for workers in 1999. Moreover, in 1999, only 16.9 percent of men and only 8.9 percent of women aged sixty-five or over remained in the work force.

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59Steuerle & Bakija, supra note 57, at 41.
60Committee For Economic Development, supra note 3; see also Samwick, supra note 12, at 212.
612000 Green Book, supra note 56, at 23.
62Id., at 994. Around 22% (28% of men and 18% of women) ages 65 to 69 participate in the labor force. Joseph F. Quinn, Has the Early Retirement Trend Reversed?, in First Annual Joint Conference for the Retirement Research Consortium on New Developments in Retirement Research, 8 (May 20-21, 1999).

Tax Lawyer, Vol. 54, No. 1
TABLE 6: Percentage of Workers Electing Social Security Retirement Benefits at Various Ages, Selected Years 1940-95*63

<table>
<thead>
<tr>
<th>Year</th>
<th>Age 62</th>
<th>Ages 63-64</th>
<th>Age 65</th>
<th>Ages 66+</th>
<th>Average Age</th>
</tr>
</thead>
<tbody>
<tr>
<td>1940</td>
<td>**</td>
<td>**</td>
<td>8.3</td>
<td>91.7</td>
<td>68.7</td>
</tr>
<tr>
<td>1950</td>
<td>**</td>
<td>**</td>
<td>23.1</td>
<td>76.9</td>
<td>68.5</td>
</tr>
<tr>
<td>1960</td>
<td>10.0</td>
<td>7.9</td>
<td>35.3</td>
<td>46.7</td>
<td>66.2</td>
</tr>
<tr>
<td>1970</td>
<td>27.8</td>
<td>23.2</td>
<td>36.9</td>
<td>12.1</td>
<td>64.2</td>
</tr>
<tr>
<td>1980</td>
<td>40.5</td>
<td>22.2</td>
<td>30.7</td>
<td>6.6</td>
<td>63.7</td>
</tr>
<tr>
<td>1990</td>
<td>56.6</td>
<td>20.2</td>
<td>16.6</td>
<td>6.7</td>
<td>63.6</td>
</tr>
<tr>
<td>1995</td>
<td>58.3</td>
<td>19.5</td>
<td>16.3</td>
<td>6.0</td>
<td>63.6</td>
</tr>
<tr>
<td>1999</td>
<td>58.6</td>
<td>18.8</td>
<td>15.6</td>
<td>7.0</td>
<td>63.7</td>
</tr>
</tbody>
</table>

* Excludes conversions at age 65 from disability to retirement rolls.
** Retirement before age 65 was not available.

Table 7 provides more detailed information about the labor force participation of men of various ages since 1950.64 For example, Table 7 shows that almost half of the men aged seventy in 1950 were still working that year, as were seventy-two percent of men aged sixty-five, and eighty percent of those aged sixty-two. By 1985, however, only sixteen percent of seventy-year-old men were working, along with thirty-one percent of sixty-five-year-old men and seventy-one percent of sixty-year-old men. The labor force participation rates of older men have remained fairly stable since 1985.65 Similarly, Chart II shows how the labor force participation of men aged 55 and older has changed over the years 1950 to 1998.66
TABLE 7: Male Labor Force Participation Rates (%) by Age, 1950 to 1998

<table>
<thead>
<tr>
<th>Age</th>
<th>Year</th>
<th>55</th>
<th>60</th>
<th>62</th>
<th>65</th>
<th>68</th>
<th>70</th>
<th>72</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>90.6</td>
<td>84.7</td>
<td>81.2</td>
<td>71.7</td>
<td>57.7</td>
<td>49.8</td>
<td>39.3</td>
<td></td>
</tr>
<tr>
<td>1960</td>
<td>92.8</td>
<td>85.9</td>
<td>79.8</td>
<td>56.8</td>
<td>42.0</td>
<td>37.2</td>
<td>28.0</td>
<td></td>
</tr>
<tr>
<td>1970</td>
<td>91.8</td>
<td>83.9</td>
<td>73.8</td>
<td>49.9</td>
<td>37.7</td>
<td>30.1</td>
<td>24.8</td>
<td></td>
</tr>
<tr>
<td>1975</td>
<td>87.6</td>
<td>76.9</td>
<td>64.4</td>
<td>39.4</td>
<td>23.7</td>
<td>23.7</td>
<td>22.6</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>84.9</td>
<td>74.0</td>
<td>56.8</td>
<td>35.2</td>
<td>24.1</td>
<td>21.3</td>
<td>17.0</td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>83.7</td>
<td>71.0</td>
<td>50.9</td>
<td>30.5</td>
<td>20.5</td>
<td>15.9</td>
<td>14.9</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>85.3</td>
<td>70.5</td>
<td>52.5</td>
<td>31.9</td>
<td>23.4</td>
<td>17.1</td>
<td>16.4</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>81.1</td>
<td>68.9</td>
<td>51.3</td>
<td>33.5</td>
<td>22.4</td>
<td>20.6</td>
<td>16.0</td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>82.7</td>
<td>67.8</td>
<td>53.7</td>
<td>33.7</td>
<td>25.8</td>
<td>20.9</td>
<td>14.7</td>
<td></td>
</tr>
</tbody>
</table>

CHART II: Labor Force Participation of Men Aged Fifty-Five and Older, 1950-1998

67 Quinn, supra note 62, at Table 1.
68 U.S. GEN. ACCOUNTING OFFICE, supra note 66, at 15.

Tax Lawyer, Vol. 54, No. 1
2. The Trend Toward Defined Contribution Plans

In recent years, there has been a marked shift away from traditional defined benefit plans and toward defined contribution plans (and cash balance plans).69 For example, as of 1993, about forty-three percent of private-sector workers were covered by at least one pension plan.70 Defined contribution plans comprised eighty-eight percent of these plans, up from sixty-seven percent in 1975.71 Moreover, forty-two percent of the active participants in private-sector plans had a defined contribution plan as their primary plan, up from just thirteen percent in 1975.72 Similarly, in 1993, eighty-eight percent of private employers with only one retirement plan sponsored only a defined contribution plan, up from sixty-eight percent in 1984.73 Also of note, 401(k) plans are the fastest growing part of the defined contribution world.74 In 1995, for example, there were 201,000 401(k) plans, up from 17,000 in 1984, and the total number of active participants increased from eight million to twenty-eight million over that period.75

At the same time, the nature of the defined benefit plan has been moving away from the traditional final average pay model. According to a recent survey of large U.S. employers offering a defined benefit plan, the percentage utilizing a final average pay formula has decreased from eighty-two percent to seventy-two percent over the past five years.76 Similarly, the percentage of large defined benefit plans using a career average pay formula has declined from fifteen percent in 1995 to nine percent today. At the same time, however, utilization of cash balance plans has increased from six percent to sixteen percent. All in all, the era of the traditional defined benefit plan is largely behind us.77

70EMPLOYEE BENEFIT RESEARCH INSTITUTE, EBRI DATABOOK ON EMPLOYEE BENEFITS, chap. 10 (4th ed. 1997), at 81.
71Id.
72Id.
74I.R.C. § 401(k). Under a section 401(k) plan, a worker can choose between receiving cash currently or deferring taxation by placing the money in an employer-sponsored retirement account. Consequently, they are sometimes called cash or deferred arrangements (CODAs).
77Edward A. Zelinsky, ERISA and the Emergence of the Defined Contribution Society, in NEW YORK UNIVERSITY - PROCEEDINGS OF THE FIFTY-SEVENTH INSTITUTE ON FEDERAL TAXATION, EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION, chap. 6 (Alvin D. Lurie ed., 1999). Yakoboski views the shift to individual account-type plans as “a plus for workers.” Yakoboski, supra note 75, at 32. He believes that the enhanced portability inherent in defined contribution plans and cash balance plans provides a better match for today’s mobile workforce. See also Pamela Perun & C. Eugene Steuerle, ERISA, at 50: A New Model for the Private Pension System (Urban Institute Retirement Project, Occasional Paper No. 4, 2000).
3. The Decline of Annuitization

The general decline of annuitization among American workers presents another significant retirement plan trend. The shift to defined contribution plans tells part of the story, but defined benefit plans are also changing. For example, one study of medium and large defined benefit pension plans found that twenty-three percent of participants were permitted to take a lump sum distribution by 1997, up from fourteen percent in 1991. Moreover, lump sum payouts are becoming increasingly prevalent among defined contribution plans, and a declining fraction of participants receive the option of a life annuity. For example, one study of the plans of medium and large firms found that just twenty-seven percent of those with 401(k) plans offer an annuity option. While, according to the study, ninety percent of participants in savings and thrift plans had access to lump sum payouts, only one-quarter had access to an annuity.

4. The Work Force Is Aging, and There Is a Trend Toward Phased Retirement and Bridge Jobs

As America ages, the work force will need to change. Due to lower birth rates following the baby boom, the number of young workers declined by fourteen percent in the 1990s, and the nation will experience a shortage of talented young workers for decades to come. The ratio of seven working age persons for every elderly person in the United States in 1950 will drop to less than three-to-one by 2030. Consequently, employers will want to find ways to retain their productive older workers.

In the time since the repeal of mandatory retirement, so-called “phased” or gradual retirement has started to replace the traditional “cliff” retirement pattern in which older workers would leave the work force and never return. Many older Americans stay in or re-enter the work force, especially in part-time and contingent work situations. According to a recent survey by Watson Wyatt,
sixteen percent of companies surveyed now offer phased retirement programs.\(^6\)

Also, according to one estimate, roughly one-third of older workers leave their long-held career jobs in favor of new jobs that serve as a bridge to full retirement.\(^7\)

D. The Need for Adequate Retirement Incomes

The combination of earlier retirements and longer life expectancies has led a number of analysts to express concern about the financial prospects of elderly retirees in the twenty-first century.\(^8\) The U.S. population currently consists of around thirty-five million residents ages sixty-five and over and around four million ages eighty-five and over.\(^9\) By 2020, however, it will include more than fifty-three million residents ages sixty-five and over and almost seven million ages eighty-five and over.

The economic problems of these elderly citizens will prove of paramount importance to the nation in the twenty-first century. In particular, the nation must consider the cost of supporting the retired population. According to Lawrence Thompson, a senior fellow at the Urban Institute, the economic cost of supporting the elderly should be evaluated in terms of the fraction of society’s goods and services consumed by the retired.\(^0\) Specifically, the cost of supporting the retired is simply the product of three different economic and demographic ratios:

1. the aggregate consumption ratio, which is the fraction of total economic activity devoted to producing consumer goods and services;
2. the retiree dependency ratio, which is the fraction of the population that is retired (which is going to be very similar to the aged dependency ratio); and
3. the living standards ratio, which is the ratio of the average consumption of a retired person to the average consumption of all persons.\(^1\)

This formulation can be used to illustrate some rather direct and simple relationships between the ratios and the cost of supporting the elderly.\(^2\) For ex-

\(^{6}\)WATSON WYATT, supra note 53.

\(^{7}\)COMMITTEE FOR ECONOMIC DEVELOPMENT, supra note 3.


\(^{9}\)Hobbs & Damon, supra note 4.


\(^{11}\)Id.

\(^{12}\)Id., at 41.
ample, a ten percent increase in the retired population will result in a ten percent increase in the cost of supporting the retired. In that regard, only about 12.8 percent of the U.S. population consists of persons age sixty-five or over today; but, by 2020, 15.7 percent of the population will be sixty-five or older. That is almost a twenty-three percent increase (122.66 percent equals 15.7 percent divided by 12.8 percent). Similarly, by 2020, fully 2.1 percent of the U.S. population will consist of persons age eighty-five and over, up from 1.6 percent in the year 2000.

It is striking that so many Americans retire while they are still productive. Indeed, more than half of new Social Security beneficiaries claim their benefits at age sixty-two, and seventy-two percent of new beneficiaries claim them before age sixty-five.94 Many retirees will have the resources to enjoy all of their golden years, but others may face economic hardships after they exhaust their resources.

II. ERISA AND INTERNAL REVENUE CODE PROVISIONS THAT INFLUENCE THE WORK AND RETIREMENT DECISIONS OF INDIVIDUALS

This Part examines the provisions of ERISA and the Internal Revenue Code that have an impact on the work and retirement decisions of older Americans. The United States operates under a voluntary pension system; private employers need not have pensions, but ERISA applies if they do. Also, although not technically covered by ERISA, individual retirement accounts (IRAs) and public-sector pension plans often fall within similar rules under the related Internal Revenue Code provisions. All of these retirement plans qualify for significant tax advantages.95

Subpart A identifies the principal provisions of ERISA and the Internal Revenue Code that make specific reference to age, and Subpart B identifies other ERISA and Code provisions that have a significant impact on the timing of retirement. Next, Subpart C identifies some other ERISA and Code provisions that have more modest effects on the work and retirement decisions of the elderly. Finally, any provision that results in an impact on the accumulation and preservation of benefits can produce at least an indirect impact on the timing of retirement by virtue of its income (wealth) effect.

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93Hobbs & Damon, supra note 4, at Table 5-3.
95Basically, an employer’s contributions to a tax-qualified pension plan on behalf of an employee are not taxable to the employee. I.R.C. § 402. Nevertheless, the employer is allowed a current deduction for these contributions (within limits). I.R.C. § 404. Moreover, the pension fund’s earnings on these contributions are tax-exempt. I.R.C. § 501(a). Workers pay tax only when they receive distributions of their pension benefits, and, at that point, the usual rules for taxing annuities apply. I.R.C. §§ 72, 402. Individual Retirement Accounts (IRAs) receive similar tax advantages. I.R.C. §§ 219, 408.

Tax Lawyer, Vol. 54, No. 1
A. Specific Age Provisions

1. Normal Retirement Age; Form and Timing of Distributions

ERISA defines normal retirement age as the earlier of the time specified in the plan, or the latter of age sixty-five or the fifth anniversary of the time the employee commenced participation in the plan.96 Unless the participant elects otherwise, benefit payments must commence not later than the sixtieth day after the latest of the end of the plan year in which the participant 1) reaches the earlier of sixty-five or normal retirement age, 2) completes ten years of service, or 3) terminates service with the employer. If the plan provides for early retirement, participants who met the service requirements but separated from service before satisfying the age requirement are entitled to actuarially reduced benefits upon reaching the early retirement age.

Defined benefit plans typically pay benefits in the form of a lifetime annuity.97 For married couples, joint and survivor annuities and pre-retirement survivor annuities represent the default form of distribution.98 In recent years, however, defined benefit plans have been moving away from paying annuities, with more and more plans offering installment and lump sum distribution alternatives.99

2. The Penalty on Distributions Before Age 59 1/2 (The Premature Distribution Penalty)

Section 72(t) generally provides that distributions before age 59 1/2 from retirement plans are subject to an additional ten percent income tax.100 Fifteen exceptions to this ten-percent penalty currently exist.101 For example, the Code excepts distributions that take the form of a lifetime annuity.102 Exceptions also provide for distributions on account of disability or to cover high medical expenses, and distributions from an IRA can even be used to purchase a residence or pay college tuition.103

3. The Requirement that Distributions Commence Soon After Age 70 1/2 (The Minimum Distribution Rules)

Section 401(a)(9) generally requires participants in retirement plans to begin taking distributions soon after they reach age 70 1/2.104 An exception allows

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96I.R.C. § 411(a)(8); ERISA § 3(24); 29 U.S.C. § 1002.
97Reg. § 1.401-1(b)(1).
99Mitchell, supra note 46, at 18.
100I.R.C. § 72(t).
103I.R.C. § 72(t)(2)(B), (E).
104I.R.C. § 401(a)(9). More specifically, distributions typically must begin no later than April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2. Distributions after the death of a plan participant must also meet certain minimum distribution requirements.
most older workers with a pension plan from their current employer to delay distributions until they retire, but IRA holders and workers with pensions from prior employers must still begin taking distributions soon after they reach age 70 1/2. Failure to take the required minimum distribution can result in a fifty percent excise tax on the excess of the amount required to have been distributed over the amount actually distributed. In addition, a plan that fails to make the required minimum distributions may be disqualified.

4. The Limitation on In-Service Distributions, Unless the Employee Has Attained Normal Retirement Age

Generally, the Code prohibits qualified pension plans from making distributions to active employees. This requirement stems from a Treasury regulation defining qualified pension plans in a way that allows them to make distributions only in the event of retirement, death, disability, or other severance from employment. This rule makes phased retirement difficult for workers.

5. Age Discrimination Provisions

The Age Discrimination in Employment Act of 1967 (ADEA) outlawed mandatory retirement before the age of sixty-five. The limit was raised to seventy in 1978 and finally removed altogether in 1986. The Act generally prohibits employers from discriminating against workers over the age of forty. Since 1988, employers have been prohibited from ceasing benefit accruals for employees who work beyond age sixty-four and from excluding participants who are hired within five years of normal retirement age.

Section 411(b)(1)(H) prohibits a defined benefit plan from ceasing accruals, or reducing the rate of benefit accruals, “because of the attainment of any age.” Similarly, section 411(b)(2)(A) prohibits a defined contribution plan from ceasing allocations, or reducing the rate at which amounts are allocated, to a participant’s account, “because of the attainment of any age.” ERISA and ADEA contain parallel provisions.

105I.R.C. § 4974.
107Reg. § 1.401-1(b)(i). Less restrictive withdrawal rules apply to profit-sharing, stock bonus, and 401(k) plans. Reg. § 1.401-1(b)(ii); VanDerheij & McDonnell, supra note 81, at 53-56. For example, amounts may generally be withdrawn from profit-sharing and stock bonus plans after they have been in the plan for two years, and earlier distributions may be permitted in the event of retirement, death, disability, other separation from service, or hardship. As for 401(k) plans, elective deferrals may be distributed on account of separation from service, death, disability, attainment of age 59 1/2, or hardship.
109The latter change likely increased the cost of hiring older workers. Mitchell, supra note 46, at 10; Patricia L. Scahill, Twenty-five Years of ERISA Leaves Defined Benefit Plans Battered and Bruised, 15 (No. 4) BENEFITS Q. 34-37 (1999).
These statutes clearly forbid a cessation of benefit accruals or a reduction in the rate of benefit accruals because of age, but they do not automatically prohibit benefit reductions that correlate with age.111 Indeed, these statutes expressly state that a plan will not fail solely because it limits the total amount of benefits that the plan provides or the total number of years that can be used to compute benefits. Still other exceptions permit subsidized early retirement benefits, Social Security supplements, and disability benefits, even though the value of such plan provisions may decline as workers age. Despite the general prohibition on age discrimination, firms are still allowed to use pension windows to encourage older workers to leave their jobs.112

B. Other Provisions that Have a Direct Impact on the Timing of Retirement


ERISA does not mandate any specific benefit levels, nor does it require that benefits accrue evenly over time.113 In keeping with the voluntary nature of our pension system, employers currently possess relatively great freedom in the design of their retirement plans. Employers face few restrictions with respect to benefit accrual.

ERISA’s primary benefit accrual rule prevents defined benefit plans from too much backloading of benefit accruals at the end of an employee’s career.114 Defined benefit plans must use one of three alternative formulas to determine the minimum rate at which benefits accrue. Like ERISA’s vesting rules,115 these minimum benefit accrual formulas serve to ensure that long-service employees will earn significant retirement benefits even if they change employers before the ends of their careers.

As already mentioned, another benefit accrual rule bars employers from reducing or ceasing an employee’s benefit accruals because of age.116 Nevertheless, employers are permitted to design their plans in ways that result in benefit reductions that correlate with age by, for example, restricting the number of years of benefit accrual.117

113Yakoboski, supra note 75, at 22.
114ERISA § 204; 29 U.S.C. § 1054; I.R.C. § 411(b). As more fully described in Section I.B.3., supra, plans are permitted to disproportionately backload benefit accruals in favor of long-service workers, but these sections impose some limits.
2. **Limits on Benefits and Contributions**

The Internal Revenue Code limits the amount of annual benefits that can be paid by a defined benefit plan.\(^{118}\) In the year 2001, the Code limits the highest annual benefit payable to a retiree to $140,000 or one hundred percent of compensation.\(^{119}\) In this regard, $170,000 represents the highest amount of compensation that can be considered in determining benefits in the year 2001.\(^{120}\) The Code permits various definitions of compensation.

If retirement benefits begin before the participant has reached the full Social Security retirement age (currently sixty-five), the dollar limit (the lesser of $140,000 or one hundred percent of compensation) must be actuarially reduced.\(^{121}\) On the other hand, if a participant delays retirement past the normal retirement age, the dollar limit actuarially adjusts upward to permit (but not require) the payment of additional benefits.\(^{122}\) The Code also reduces the applicable dollar limit for workers with fewer than ten years of participation.\(^{123}\)

C. **Other Provisions that Have an Impact on the Work and Retirement Decisions of the Elderly**

A variety of other ERISA and Internal Revenue Code provisions can affect the work and retirement incentives of elderly Americans.

1. **Coverage and Participation Rules**

Under the minimum coverage rules, a pension plan must benefit a certain percentage of employees.\(^{124}\) In applying the minimum coverage rules, plans may exclude employees who are under age twenty-one or who have not completed one year of service.\(^{125}\) However, they cannot exclude older workers from participation on the basis of age.\(^{126}\) The term “year of service” means any twelve-month period during which an employee has worked at least one thousand hours.\(^{127}\)

These rules generally require employers to provide pension benefits to older workers who work at least one thousand hours a year. Consequently, these rules

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\(^{118}\)I.R.C. § 415(b). Along the same lines, I.R.C. § 415(c) provides limits on the amount of contributions that can be made to a defined contribution plan each year on behalf of an employee. In the year 2001, for example, not more than the lesser of $30,000 or 25% of the participant’s compensation may be added to the participant’s account. These limits appear only in the Internal Revenue Code, and they reflect the government’s desire to limit the ability of high-income workers to utilize the tax benefits of pension plans.


\(^{120}\)Id.

\(^{121}\)I.R.C. § 415(b)(2)(C).

\(^{122}\)I.R.C. § 415(b)(2)(D).

\(^{123}\)I.R.C. § 415(b)(5)(A).

\(^{124}\)I.R.C. § 410(b).

\(^{125}\)ERISA § 202(a)(1); 29 U.S.C. § 1052(a)(1); I.R.C. § 410(a)(1).

\(^{126}\)ERISA § 202(a)(2); 29 U.S.C. § 1052(a)(2); I.R.C. § 410(a)(2). ERISA used to allow plans to exclude employees who were hired within five years of the plan’s normal retirement age. The 1986 amendments to ADEA changed ERISA to prohibit that practice. Scahill, supra note 109, at 34-37.

make phased retirement difficult, and they may discourage employers from hiring older workers for jobs that require more than one thousand hours of work per year.\textsuperscript{128} For example, the Travelers Companies limit the number of hours that their retirees can work to just 960 hours per year.\textsuperscript{129}

2. \textit{Vesting Rules}

ERISA’s vesting rules can also have an impact on the work and retirement decisions of elderly Americans. ERISA generally permits employers to require up to five years of service before any employee’s benefit accruals vest.\textsuperscript{130} Allowing employers to require a long period of service before benefits vest, however, can make work less attractive for new elderly workers who do not anticipate staying with the employer long enough to vest.

3. \textit{Potpourri}

To the extent that other ERISA and Internal Revenue Code provisions make retirement savings more or less attractive, these, too, can influence the time of work and retirement. For example, the greater wealth that results from the tax advantages associated with retirement savings will enable workers to retire earlier.

Plan provisions allowing lump sum distributions may yield mixed effects.\textsuperscript{131} Early eligibility for a lump sum distribution may induce workers to retire early. On the other hand, the tendency to dissipate lump sum distributions may result in a need for workers to work longer in order to accumulate sufficient savings for retirement.

Similarly, the ability to borrow from a plan may encourage greater contributions and accumulations by some workers, leading to earlier retirement;\textsuperscript{132} however, other workers may end up dissipating their retirement assets prematurely.

\textsuperscript{128}COMMITTEE FOR ECONOMIC DEVELOPMENT, \textit{supra} note 3.


\textsuperscript{131}In that regard, one recent study found that 57% of 401(k) plan participants choose to take cash payments when changing jobs, instead of rolling over the balance to their new employers’ plans or IRAs. Press Release, Hewitt Company, \textit{Hewitt Study Shows More Than Half of 401(k) Plan Participants Opt for Cash When Changing Jobs} (Sept. 13, 1999), available at http://www.hewitt.com/resource/newsroom/pressrel/1999/09-13-99.html (last visited Oct. 10, 2000). Similarly, another study estimated that lump sum distributions reduce annual retirement income by $1,000 - $3,000. See Leonard E. Burman et al., \textit{Lump Sum Distributions from Pension Plans: Recent Evidence and Issues for Policy and Research}, 52 Nat’l Tax. J. 553 (1999). Halperin and Munnell suggest that some $20 billion a year leaks out of the retirement system. Halperin & Munnell, \textit{supra} note 17, at 12. On the other hand, another study found that most lump-sum distributions are small, leading them to conclude that the leakage from the pension system is not significant relative to retirement income. See John Sabelhaus & David Weiner, \textit{Disposition of Lump-Sum Pension Distributions: Evidence from Tax Returns}, 52 Nat’l Tax. J. 593 (1999).

\textsuperscript{132}According to the General Accounting Office, more than 75% of workers with defined contribution plans are allowed to borrow from them. U.S. GEN. ACCOUNTING OFFICE, \textit{supra} note 16, at 49. Nearly 8% of these workers have outstanding loans, with an average balance of $3,000.

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and find themselves needing to work longer to order to accumulate sufficient savings for retirement.

III. WHERE DO WE GO FROM HERE?

A. Recent Policy Changes

The government has long been concerned about the retirement income needs of the elderly and about the impact of public policy on the timing of retirement. Indeed, over the years, Congress has passed a number of laws with the express intention of removing impediments to work by the elderly. In particular, the ADEA outlawed mandatory retirement before the age of sixty-five. The limit was raised to seventy in 1978 and finally removed altogether in 1986. The Act generally prohibits employers from discriminating against workers over age forty.

In other pertinent changes:
- The Taxpayer Relief Act of 1997 repealed the excise taxes on excess pension distributions and accumulations (former I.R.C. section 4980A);
- The Small Business Job Protection Act of 1996 modified the minimum distribution rules to permit most ongoing workers to postpone benefit distributions until after age 70 1/2;
- The Unemployment Compensation Amendments of 1992 encouraged rollovers of lump sum distributions into qualified retirement accounts by, for example, withholding twenty percent from lump sum distributions that are not rolled over into qualified retirement accounts (I.R.C. section 3405(c));
- The Tax Reform Act of 1986 established faster minimum vesting schedules (for example, five year “cliff” vesting) and imposed an excise tax on most distributions received before age 59 1/2 (I.R.C. section 72(t));
- The Revenue Act of 1978 established 401(k) plans and simplified employee pensions (SEPs);134
- The Social Security Amendments of 1983 required the gradual increase in the Social Security retirement age from sixty-five to sixty-seven; and
- The Senior Citizens’ Freedom to Work Act of 2000 repealed the limitation on the amount of outside income that may be earned by Social Security beneficiaries who have attained retirement age (the earnings test) without incurring a reduction in benefits.136

B. Competing Interests Muddy Future Pension Policy

Government legislation often reflects battles among competing interests, and this certainly seems true for federal pension policy. Employers use pension plans

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133 See id.; see also CONGRESSIONAL BUDGET OFF., supra note 88.
134 Yakoboski, supra note 75, at 32-37.
135 On the other hand, Medicare was changed in 1982 to make employers the primary payers of health insurance benefits for their older employees. Returning Medicare to its original first payer rules would help encourage the employment of older workers. See COMMITTEE FOR ECONOMIC DEVELOPMENT, supra note 3; see also Burkhauser & Quinn, supra note 112, at 16.
to encourage older workers to retire, and employees want the freedom to retire as early as they like.  

On the other hand, the government maintains a paternalistic interest to ensure that workers and their families will receive adequate incomes throughout their retirement years. Unfortunately, the interests of employers, employees, and the government do not always coincide.

In particular, government policies permit companies to use their tax-favored pension plans to encourage their older employees to retire at earlier and earlier ages. Moreover, government policies do not affirmatively counteract the myopic decision-making of older workers—that is, their tendency to underestimate their life expectancies and overvalue their retirement assets. In short, federal pension policy is filled with non-neutralities, many of which discourage the elderly from remaining in the work force.

1. The Government Has a Paternalistic Interest in Keeping the Elderly at Work

Americans typically believe that the government has little business telling employers and workers what to do with their money. Nevertheless, Americans empower the government to enact paternalistic Social Security and pension policies to ensure that workers will save for their retirements. The Social Security system, for example, collects payroll taxes from virtually all workers and uses those receipts to pay benefits to virtually all retirees and their families. Private pension policy also possesses many paternalistic features. The limitations on early withdrawals and loans, for example, help ensure that retirement savings will be available to meet retirement needs. Similarly, the qualified joint and survivor annuity regime stems from paternalistic governmental efforts to achieve adequate retirement incomes for the spouses of plan participants. The government could do more if it really wanted to ensure that participants and their families have adequate incomes throughout their retirement years.

The government might want to enact policies that affirmatively encourage elderly workers to remain in the work force until they have accumulated enough resources to ensure that they will have adequate incomes throughout their retirement years. At the very least, the government might want age-neutral policies

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137U.S. GEN. ACCOUNTING OFFICE, supra note 66.


141If retirement income adequacy were the only goal guiding government action, the government would find it relatively easy to ensure that every American would have adequate retirement income. The government could achieve this goal by, for example, expanding the current Social Security system or mandating some type of universal private pension system. See Jonathan B. Forman, Universal Pensions, 2 CHAPMAN L. REV. 95, 108 (1999); PRESIDENT'S COMMISSION ON PENSION POLICY, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY (1981).
that enable workers “to retire, remain in the work force, or return to the work force without discrimination or economic disadvantage.”\textsuperscript{142} The government might also want to enact policies to counteract the myopic decision-making of older workers. The remainder of this Subpart outlines how government policy could address these goals, and Part IV details a number of specific changes that could help achieve one or more of these goals.

2. Encouraging Elderly Americans to Keep Working

In order to ensure that Americans have adequate incomes throughout their retirement years, the government might want to adopt policies that would require or encourage Americans to remain in the work force longer. A number of laws already encourage workers to remain in the work force until they are moderately old. In particular, full Social Security retirement benefits and Medicare generally do not become available until age sixty-five, and reduced Social Security benefits do not become available until age sixty-two.

Also, a number of pension rules encourage workers to remain in the work force until they are moderately old. In particular, many pension distribution rules are themselves keyed to the Social Security retirement age.\textsuperscript{143} In any event, the penalty on premature withdrawals discourages most Americans from taking retirement plan distributions prior to age 59 1/2.

Of course, if the government truly wanted to use pension policy to encourage elderly Americans to keep working, it could do more. For example, the government could raise the normal retirement age, and it could impose significant financial penalties on earlier withdrawals.

3. Promoting Age Neutrality (Actuarial Neutrality)

Alternatively, the government might content itself with merely promoting pension policies that are age-neutral. For example, the government might adopt rules that require pensions to achieve actuarial neutrality, at least beyond some minimum retirement age. Put simply, the government might mandate policies which ensure “that the present value of benefits accrued at a particular point in time is identical, whether those benefits are drawn early, late, or at the normal time.”\textsuperscript{144}

The current system instead permits retirement plans to be non-neutral with respect to age. For example, because early retirees will receive benefits for longer periods of time, an actuarial reduction in monthly benefits should be required, and critics often suggest that a reduction of at least six percent would

\textsuperscript{142}Libassi, \textit{supra} note 129, at 188; \textit{see also} IPPOLITO, \textit{supra} note 21, at 10-17.


\textsuperscript{144}Casey, \textit{supra} note 34, at 18.
be required for actuarial neutrality. In that regard, however, traditional defined benefit plans often encourage workers to take their benefits prior to normal retirement by providing enhanced benefits. In particular, current law permits employers to offer generous early retirement incentives and Social Security supplements. Moreover, current law permits employers to design their plans in ways that impose financial penalties on those who work past the plan’s normal retirement age by, for example, not requiring that additional years of service count toward the accrual of benefits.

On the other hand, such actuarial unfairness appears far less common with defined contribution plans or cash balance plans. Except in the unusual case in which benefit accruals cease after a specified number of years of service, these plans tend to be actuarially neutral with respect to the timing of retirement. In that regard, the shift from traditional defined benefit plans to defined contribution plans and cash balance plans may have already begun to produce a significant impact on the timing of retirement.

If the government wants to promote age neutrality in pension policy, it could enact policies to ensure that older workers continue to accrue meaningful retirement plan benefits each year that they remain in the work force. For example, as more fully explained in Part IV below, the government might want to repeal the rules that permit employers to limit the number of years of service that count toward the accrual of benefits and the rules that permit employers to provide early retirement subsidies.

4. Counteracting the Myopic Decision-Making of Older Workers

Most people think about retirement in terms of current dollars. They look at the current monthly benefits available to them from Social Security and their traditional defined benefit plans, and they look at the apparently large sums accumulated in their defined contribution plans (and generally available to them only if they retire). As a result, a kind of money illusion leads most older Americans to believe that they are better off than they really are.

Unfortunately, inflation after retirement almost invariably erodes the value of accrued pension benefits. Post-retirement inflation always presents a problem for defined contribution plans, and very few defined benefit plans are indexed for inflation. Moreover, older workers often fail to consider how their benefits and needs will change over the course of their retirement. In addition, many

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145 Mitchell, supra note 46, at 15. Similarly, Social Security benefits increase by 8.3% per year from ages 62 to 65, an amount generally considered actuarially fair for a person with an average life expectancy. See also Econ. Rep. of the President, supra note 69, at 145. At present, Social Security benefits deferred beyond age 65 are increased by just 6% annually, but that percentage is scheduled to increase to an actuarially-fair 8% per year by 2007.

146 Quinn, supra note 62, at 8; Gale, supra note 69, at 25-26.

147 Quinn, supra note 64.

older Americans underestimate their life expectancies. In short, many older Americans overestimate their financial ability to meet their future retirement income needs and, consequently, choose to retire too early.

Indeed, many workers lack even a rudimentary understanding of the financial resources required for a twenty or thirty year retirement. What looks like an adequate retirement income at age fifty-five, sixty-two, or even sixty-five may not be enough to live on at age eighty when work is not a likely option and savings have been depleted. Poverty statistics already show that Americans seventy-five and older are one-third more likely to live in poverty than those ages sixty-five to seventy-four.149

The government could combat this myopic decision-making by requiring pensions to pay benefits in the form of annuities, perhaps even indexed-for-inflation annuities. The government might also want to increase and index normal retirement age to reflect longer life expectancies.

IV. RECOMMENDATIONS AS TO HOW ERISA AND THE INTERNAL REVENUE CODE MIGHT BE CHANGED TO ENCOURAGE AMERICANS TO REMAIN IN THE WORK FORCE

This Part summarizes a number of policy changes that could influence the work and retirement decisions of elderly workers. At the outset, Subpart A explains some specific changes that could be made to ERISA and the Internal Revenue Code in order to encourage the elderly to remain in the work force. Next, Subpart B outlines some other changes that would be needed to achieve true age neutrality in the timing of retirement. Subpart C then discusses how indexed annuities could help ensure that elderly Americans have adequate incomes throughout their retirement years. Finally, Subpart D gathers together a few other policy recommendations pertinent to this area.

A. Change Specific ERISA and Internal Revenue Code Provisions

1. **Raise the Eligibility Age for the Penalty on Premature Withdrawals from 59 1/2 to 62**

I.R.C. section 72(t) generally imposes a ten percent tax on distributions before an individual reaches age 59 1/2. Changing this penalty on premature withdrawals could have a significant impact on the timing of retirement. In particular, it could make sense to raise the eligibility age to sixty-two and keep it tied to Social Security’s early retirement age, even if that age is itself increased.150

All signs indicate that raising the age of initial eligibility for retirement benefits would increase the average age of retirement. For example, in the Social Security context, a good deal of evidence suggests that the age of initial eligibility for benefits “appears to be the most powerful influence” on the timing of

149 Committee for Economic Development, supra note 3.

150 See Pratt & Bennett, supra note 101, at chap. 5; see also Steuerle & Spiro, supra note 143.
Retirement levels have long spiked at Social Security’s early retirement age of sixty-two, with more than half of new Social Security beneficiaries claiming their benefits at that age.\(^{152}\)

The government could eliminate virtually all the exceptions to the premature distribution penalty that currently allow many individuals to receive penalty-free withdrawals even before age 59 1/2.\(^{153}\) In addition to making the premature distribution penalty a more effective deterrent to early withdrawals, the government could significantly increase the tax rate. An alternative approach would significantly limit, or completely eliminate, the right to make withdrawals before the age of initial eligibility. In any event, the government could require that all lump sum distributions be rolled over into another qualified plan or IRA.

2. Raise the Minimum Distribution Age or Repeal the Rule

I.R.C. section 401(a)(9) generally requires participants in retirement plans to begin taking distributions soon after they reach age 70 1/2. An exception allows older workers with a pension plan from their current employer to delay distributions until they retire, but IRA holders and workers with pensions from prior employers must still begin taking distributions soon after they reach age 70 1/2. Admittedly, most elderly Americans have retired long before age 70 1/2. Nevertheless, by compelling many of the remaining elderly American workers to take retirement distributions soon after age 70 1/2, these rules invariably push still more elderly workers into retirement. Consequently, repeal or reform of these rules could help encourage those elderly workers to remain in the work force.\(^{154}\)

Mark J. Warshawsky of TIAA-CREF has forcefully argued that the minimum distribution rules are outmoded in today’s labor market and social conditions.\(^{155}\) He notes that people are living longer and working at older ages, and he contends that retirement plan participants need greater flexibility in how and when they draw down their pension assets. He also argues that the minimum distribution requirements prove burdensome for plan sponsors and providers and confusing for plan participants. Consequently, he suggests that Congress should repeal the minimum distribution rules or, at least, raise the required start date from 70 1/2 to seventy-six.

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\(^{153}\)Pratt & Bennett, supra note 101.


3. **Repeal the Age Discrimination Exceptions**

Retirement plans are prohibited from reducing benefit accruals “because of the attainment of any age.” Unfortunately, exceptions allow plans to limit the total amount of benefits or the total number of years used to compute benefits. Still other exceptions allow plans to provide subsidized early retirement benefits and Social Security supplements. Employers take advantage of these exceptions to induce older workers into early retirement.

It is not at all clear why federal retirement policy should continue to allow employers to use tax-preferred retirement savings to induce their older workers into early retirements. This indicates that it would make sense to repeal some or all of these exceptions to the age discrimination rules. Of course, any time Congress adopts changes of this magnitude, it would be appropriate to provide plan sponsors with generous transition rules.

a. **How Repealing the ADEA Exceptions Would Change the Timing of Retirement.** A few examples might help clarify the issues involved here.

(1) **Repealing the years of service exception.** Under current law, employers, particularly those with defined benefit plans, are relatively free to design their plans in ways that discourage older workers from remaining on the job. For example, consider a simple final average pay plan that provides workers with a pension benefit at age sixty-five equal to two percent times years of service times final average pay. Under current law, the plan may also provide that no more than thirty years of service may be counted in computing a worker’s retirement benefits. In that situation, the maximum benefit payable to any worker would be just sixty percent of final average pay. Final average pay might go up if a worker remained on the job for more than thirty years, but a worker with thirty-five years of service would still receive a benefit of just sixty percent of her then final average pay (sixty percent equals two percent times not more than thirty years of service). With this type of plan design, the employer is able to reduce the rate of benefit accruals for workers who stay past thirty years and so induce them to retire.

In short, current law allows employers to design their plans in a way that imposes financial penalties on those who stay too long, even though those financial penalties have a disparate impact on older workers. On the other hand, if the years of service exception to the age discrimination rules was repealed, the hypothetical worker in the last paragraph presumably would be entitled to a

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158 According to a recent study of the pension plans of medium and large pension firms, some 31% of the defined benefit plan participants studied faced a maximum limit on years of service in 1997. Mitchell, *supra* note 46, at 17. That study also found that 33% of participants faced a ceiling on the maximum dollar amount of benefits that could be paid to them.

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retirement benefit of seventy percent of her then final average pay after thirty-five years of service. That would significantly reduce the financial incentive to retire at thirty years of service.

(2) Repealing the subsidized early retirement exceptions. Similarly, current law permits plan sponsors to subsidize early retirement in a whole range of ways that presumably would otherwise violate the age discrimination laws. For example, the plan in the last example might give early retirees the full sixty percent of final average pay even if they have only twenty-five years of service. Alternatively, the plan might provide greater than actuarily fair subsidies for those workers who have thirty years of service but who have not yet reached age sixty-five. Or, the plan might provide supplemental benefits to workers who are not yet eligible for Social Security. Each of these approaches is used to create financial incentives for older workers to retire, and some are even used to impose financial penalties on older workers who wish to remain on the job.

Consequently, it could make sense to repeal these age discrimination exceptions. This change would curtail the ability of employers to use plan design provisions and tax-favored plan assets to provide explicit financial incentives for early retirement. As a result, a greater number of older workers would remain at work.

b. Transition Rules. If the age discrimination exceptions are repealed, however, it would be appropriate to provide plan sponsors with generous transitional relief. For a variety of reasons, older workers present higher costs of employment relative to their productivity. As a result, simply repealing the age discrimination exceptions would force many employers to pay compensation to older workers that exceeded their productivity, and that would not be fair.

The most generous transition rule would repeal the age discrimination exceptions effective for new employees only. Alternatively, the repeal could be made applicable only to workers then under the age of forty or fifty. Another approach would make the repeal effective only for benefit accruals after the date of enactment.

Even with generous transition relief, there is a danger that some employers might find that they would no longer want to maintain their retirement plans. Many employers value their current ability to use retirement plans as a work force management tool. Consequently, if the government were to eliminate the ability of employers to use retirement plans to induce early retirements, some employers might choose to terminate their plans. This certainly could happen in our voluntary pension system.

4. Change the Limits on Benefits and Contributions

Section 415(b) limits the annual benefit that can be paid by a defined benefit plan at the Social Security retirement age to the lesser of $140,000 (in the year

159For example, it typically costs employers more to provide traditional pension and health benefits for older workers than for younger workers, and salary costs and other benefits can also be higher. See supra note 53 and accompanying text.

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2001) or one hundred percent of the participant’s compensation. The dollar limit is actuarially reduced for benefits that are paid earlier than the Social Security retirement age. For a variety of reasons, many pension experts have called for repeal of section 415 or, at least, for an increase in the section 415 compensation limits.

To be sure, section 415 is unnecessarily complicated, and many lament that its stingy limits may actually discourage the formation of pension plans that could help expand pension coverage. Pertinent here, however, is section 415’s impact on the timing of retirement. In that regard, by limiting the maximum annual benefit that can be paid to a retiree, section 415 can discourage at least some elderly workers from remaining in the work force. On the other hand, by limiting the ability of employers to provide subsidized early retirement benefits to their workers, the section 415 limits can discourage early retirement and help keep older workers on the job.

Consider, for example, a plan that makes early retirement benefits available at age fifty-five and unreduced normal retirement benefits available at age sixty-two for workers with twenty-five years of service. The annual defined benefit limit ($140,000 in 2001) typically does not affect many plan participants. On the other hand, the early retirement reductions required by section 415(b)(2)(C) can severely limit the amount of benefits that can be paid to workers who retire early. For example, in 1999, this early retirement reduction would have limited the maximum annual benefit payable to a worker who retired at age fifty-five to just $53,931, less than forty-two percent of the $130,000 benefit limit applicable in 1999. Fanning views this outcome as “harsh and unfair.” He and others argue that the solution is to raise significantly the normal retirement benefit amount and ease the limit on early retirement benefits, perhaps by restoring the $75,000 floor on benefits paid at age fifty-five.

It could indeed make sense to relax the normal retirement age dollar limit, at least for older workers who face the cap because of already long years of service. In particular, a worker with twenty-five or thirty years of service should not be prevented from earning additional retirement benefits merely because she has already accrued a benefit equal to one hundred percent of final average pay (albeit under a rather generous plan). Alternatively, an exception might be added to permit older workers to accrue additional benefits of up to, say, two or three percent of final average pay for each additional year of service.

On the other hand, if the government wants to keep older Americans in the work force, then it makes little sense to relax the rule requiring actuarial reductions for early retirement. Employers want to relax the rule because they want more freedom to use their tax-favored pensions to provide subsidies to encour-

161See Patricia L. Scahill, supra note 109, at 38-39.
162The example comes from the remarks of Michael R. Fanning, as reported in James O. Wood, Revising ERISA for the Next 25 Years, 15 BENEFITS Q. 66, 70 (4th Q. 1999).
163Remarks of Fanning and Patricia L. Scahill, as reported in Wood, supra note 162, at 66, 69.
age their costly older workers to retire early. The government must demand actuarially fair reductions if it wants pension policy to be age-neutral as to the timing of retirement.

Indeed, even actuarially fair reductions may prove insufficient to encourage elderly workers to postpone retirement. In the Social Security system, for example, the benefit reduction for taking benefits prior to age sixty-five is considered actuarially fair (8.3 percent per year).\textsuperscript{164} Nevertheless, empirical research suggests that the related Social Security earnings test slightly discouraged labor supply, leading Henry J. Aaron of the Brookings Institution to conclude that workers presumably undervalue higher future benefits relative to the loss of current benefits.\textsuperscript{165}

In short, government policy that is at least ostensibly neutral with regard to the timing of retirement should require actuarially fair reductions in benefits paid before normal retirement age. Moreover, if the government actually wants to encourage workers to postpone retirement, then it might even want to impose greater financial penalties on early retirement (for example, by toughening the I.R.C. section 72(t) penalty on premature distributions).

B. Mandate Age Neutrality

A more comprehensive approach would be for the government to encourage or even mandate age-neutral pension policies. As already mentioned, the government could repeal the rules permitting retirement plans to limit the number of years that count for benefit accrual purposes, and it could repeal the exceptions to ADEA that permit early retirement subsidies. But there is much more that the government could do if it truly wishes to promote age neutrality in pension policy.

For example, beyond some minimum age, the government might simply require that all retirement plans be designed to be neutral with regard to the timing of retirement. In short, the government could expressly mandate age neutrality in all private retirement plans.\textsuperscript{166} Of course, with a change of this magnitude, it would be appropriate to provide plan sponsors with generous transitional relief.

An age neutrality mandate would ensure that older workers would continue to accrue meaningful retirement benefits every year that they continued to work. Presumably, benefits would accrue at a constant annual rate like they do now in the typical defined contribution plan or cash balance plan. Similarly, age neutrality would require plan changes to ensure that the value of any previously-accrued benefits would be actuarially adjusted for any delay in their receipt.

\textsuperscript{164}See Econ. Rep. of the President, supra note 69, at 144.

\textsuperscript{165}Aaron, supra note 138, at 50. Moreover, to the extent that individual workers may have insights into their own mortality risk, those who expect to die younger are given little motivation to delay benefits by an actuarial increase that is merely fair for the average worker.

\textsuperscript{166}Not surprisingly, in its recent report on opportunities for older workers, the corporate-sponsored Committee for Economic Development expressly rejected such a mandate. Committee for Economic Development, supra note 3.
The typical defined contribution plan could easily meet this type of age neutrality mandate. For example, a simple defined contribution plan might provide that an employee is entitled to a contribution of ten percent of salary each year and that accumulations earn a market rate of return. Such a plan does not impose financial penalties on those who keep working, nor does it offer any incentive for early retirement.

On the other hand, most defined benefit plans would clearly flunk an age neutrality requirement. After all, the typical defined benefit plan is disproportionately backloaded, both because benefit accruals cease after some number of years of service and also because such plans typically have backloaded benefit accrual formulas. Moreover, any plan that failed to provide full actuarial increases and reductions to reflect the timing of retirement would also run afoul of an age neutrality requirement.167

Indeed, of defined benefit plans, only cash balance plans could easily meet an age-neutrality requirement.168 Like defined contribution plans, cash balance plans have individual accounts, albeit hypothetical.169 For example, a simple cash balance plan might provide that the employee is entitled to a wage credit of ten percent of a salary each year and an interest credit equal to the market rate on the balance of the employee’s hypothetical account at the beginning of the year. Clearly, a cash balance plan like this would be age-neutral.

All in all, the net effect of mandating age neutrality would be to shift the private pension system into a world of individual accounts, both real (defined contribution plans) and hypothetical (cash balance plans). In an age-neutral world, virtually all workers would see a flat percentage of pay contributed to individual accounts on their behalf, and those workers would earn interest on their accumulations at the market rate. Under this kind of system, workers would no longer have an incentive to retire during artificially created retirement windows. Consequently, more workers would remain in the work force, accumulating assets for their eventual retirement or for their survivors.

C. Require that Benefits Be Paid as Indexed Annuities

It would also make sense for the government to encourage or even require that pension benefits be paid in the form of annuities, perhaps even indexed-for-inflation annuities.170 Annuities help ensure that workers and their families will not outlive their retirement savings.171 In that regard, the trend away from annuitization and towards lump sum distributions is quite troublesome, particu-

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167 At the very least, it makes sense to index a worker’s current salary for expected inflation. See Halperin & Munnell, supra note 17, at 24; Congressional Symposium on Women and Retirement: Hearing before the Subcomm. on Retirement Income and Retirement of the House Select Comm. on Aging, 102nd Cong., 2d Sess. 134 (1992) (Statement of Ed Burrows, pension plans).
168 Some other career average pay plans might also be able to satisfy an age-neutral requirement.
169 Forman & Nixon, supra note 25.
170 Forman, supra note 140, at 63-64; Forman, supra note 141, at 121-24; Halperin & Munnell, supra note 17, at 26-27; U.S. GEN. ACCOUNTING OFFICE, supra note 16, at 49.

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larly, because older Americans tend to be myopic in their decisions about when to retire. Many Americans retire too early because they underestimate their life expectancies, overestimate their financial resources, and fail to understand the deleterious effects of inflation. These early retirees run a serious risk of outliving their resources.

Consequently, it could make sense to require that all retirement plans pay at least a portion of their benefits in the form of an inflation-adjusted annuity. Such annuities keep the purchasing power of benefits constant over time by lowering initial benefits enough to pay for higher benefits later on. Alternatively, the government might require that all plans at least offer participants the option of taking benefits in the form of an inflation-adjusted annuity.

For example, the government might want to require that individuals take a basic pension distribution that, together with Social Security, would provide them with the equivalent of an indexed annuity that is targeted to, say, 125 percent of the poverty level. Beyond that basic annuity, however, more relaxed distribution rules might apply.

In the year 2000, for example, the poverty level for a single individual was $8,350, and the poverty level for a married couple was $11,250. Consequently, assuming a 125-percent-of-the-poverty-level target, a single individual retiring in 2000 would have needed the equivalent of an indexed annuity that paid $10,437.50 that year ($10,437.50 equals 125 percent times $8,350) and appropriately inflation-adjusted amounts in future years.

For many retirees, Social Security would provide a good chunk of this minimum 125-percent-of-the-poverty-level benefit, leaving only the balance to be made up from the worker’s pension. More specifically, the basic pension benefit accrued for a retiree might be made available under just three options:

(1) A one hundred percent payout to purchase an indexed annuity that, when coupled with Social Security, results in sufficient annual income to meet the 125-percent-of-the-poverty-level standard.

(2) Distributions as desired with only one constraint: the amount remaining in the account after withdrawal must always be at least 110 percent of the amount necessary to purchase an annuity guaranteeing the 125-percent-of-the-poverty-level standard.

(3) A combination of (1) and (2).

More relaxed rules might be applied to retirement distributions in excess of the basic amounts needed to meet the 125 percent-of-the-poverty-level standard.

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172Steuerle, supra note 148.
173Halperin & Munnell, supra note 17, at 26-27. Now that the Treasury sells inflation-indexed bonds, it should become more common for insurance companies to provide wrap-around inflation-adjusted annuities.
175Similarly, distributions for married couples might be geared towards purchasing an indexed, joint and survivor annuity (for example, an annuity paying $14,062.50 in 2000 [$14,062.50 = 125% x $11,250] and appropriately inflation-adjusted amounts in future years).

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D. Other Proposals

The income (wealth) effects of pension accumulations have a large impact on the timing of retirement. Consequently, proposals that would expand pension coverage or otherwise increase pension accruals can be expected to result in earlier retirement by more individuals. Of course, that is a good thing. We should not object to policies that would promote additional retirement savings or encourage the preservation of benefits until retirement merely because such policies would tend to result in earlier retirement.

Indeed, if the government is interested in ensuring that all elderly Americans have adequate retirement incomes, it should adopt policies that encourage retirement savings and the preservation of benefits. In that regard, it might expand coverage and participation, shorten vesting periods, restrict plan loans and lump sum distributions, and eliminate the rules that permit retirement plans to be integrated with Social Security.¹⁷⁶

V. CONCLUSION

The current pension system is fraught with financial incentives that push able-bodied elderly workers into retirement just when they should instead be encouraged to remain in the work force to accumulate additional retirement resources. This article has recommended a number of ways to change federal pension laws in order to encourage elderly workers to remain in the work force. In particular, this article has recommended repealing the rules permitting pension plans to limit the number of years that count for benefit accrual purposes and repealing the exceptions to the Age Discrimination in Employment Act that permit plans to provide early retirement subsidies.

In addition, this article has considered whether the government should do more to encourage or even mandate age-neutral pension policies. In that regard, for example, beyond some minimum age, the government might simply require that all retirement plans be designed to be neutral relative to the timing of retirement. In an age-neutral world, workers would see actuarially fair increases in their benefit accruals resulting from any delay in taking benefits, and they would see additional benefit accruals as compensation in connection with their additional years of work. Consequently, more workers would remain in the work force, accumulating assets for their eventual retirement. At the same time, however, such an age-neutrality mandate would have dramatic implications for the current pension system. In particular, there would be a further shift away from traditional defined benefit plans toward a world consisting almost entirely of individual account plans, both real (defined contribution plans) and hypothetical (cash balance plans).

¹⁷⁶Of course, if the government is really serious about ensuring that all Americans have adequate incomes throughout their retirement years, it may need to take even more dramatic action, such as expanding the current Social Security system or mandating some type of universal private pension system. See Forman, supra note 141, at 108. When compared with such changes, mandating age neutrality in the private retirement system seems tame.

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Finally, this article has considered how government policy could counteract the tendency of Americans to retire too early because they underestimate their life expectancies, overestimate their financial resources, and fail to understand the deleterious effects of inflation. In particular, this article has discussed the importance of annuities as a tool for protecting Americans against the risk of outliving their resources and recommended that the government require that virtually all retirement plans pay at least a portion of their benefits in the form of an inflation-adjusted annuity.