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An Alphabet Soup Agenda for Reform of the Internal Revenue Code and ERISA Provisions Applicable to Qualified Deferred Compensation Plans

Norman P. Stein

AN ALPHABET SOUP AGENDA FOR REFORM OF THE INTERNAL REVENUE CODE AND ERISA PROVISIONS APPLICABLE TO QUALIFIED DEFERRED COMPENSATION PLANS

*Norman P. Stein**

INTRODUCTION

SUBCHAPTER D of the Internal Revenue Code endows certain advance-funded, employer-sponsored retirement arrangements with the advantage of relatively pure income tax deferral.[1] Most of the deferral is at least originally traceable to contributions to employer-sponsored plans, although individuals may also achieve tax deferral through direct contributions to individual retirement accounts.[2] According to the tax expenditure budget prepared by the Joint Committee on Taxation, the estimated cost of the tax-deferral is currently over $100 billion annually.[3]

This article accepts that the basic tax regime associated with Subchapter D will remain a part of our tax code and assumes that the regime has an accepted policy rationale: to help as many working Americans as possible create income security for that period of life when they are no longer supporting themselves with wage income. The purpose of this article is to suggest certain changes to the Internal Revenue Code and to ERISA that would, in my view, increase the probability that employer-

* Douglas Arant Professor of Law, University of Alabama School of Law.

1. I.R.C. § 404(a) allows an employer a deduction for contributions to a qualified pension, profit-sharing or stock bonus plan. I.R.C. § 501(a) provides that the qualified funding vehicle of a qualified plan is exempt from income taxation. I.R.C. § 402(a) provides that an employee will be taxed on an interest in a qualified plan only when the benefits are distributed to him or her.

2. *See generally* I.R.C. § 219 (2002) (providing for deductions to an individual retirement account); I.R.C. § 408(e) (2002) (providing a tax exemption for the account); I.R.C. § 408(b) (2002) (deferring taxation until benefits are distributed from the account).

3. STAFF OF J. COMM. ON TAX'N, ESTIMATE OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2001-2005, at 21, JCS-1 (Comm. Print 2001). The breakdown is: $85 billion for employer plans; $5.5 billion for Keogh plans, which are plans maintained by self-employed individuals for themselves and their employees; and $10.3 billion for individual retirement accounts. The latter figure includes the foregone revenue on earnings of individual retirement accounts, some of which include amounts "rolled over" from employer plans. The $85 billion figure also includes foregone revenue from plans sponsored by state and local governments.

sponsored retirement plans will enhance the retirement security of such working people sufficiently to justify our national tax-expenditure commitment to such plans.

The verbs "accept" and "assume" in the first sentence of the prior paragraph are not chosen randomly. I write this article from the perspective of someone who believes that our nation lacks a coherent retirement policy and as one who believes a mandatory universal pension system ("MUPS"), of the sort proposed during the presidential administration of Jimmy Carter,[4] would contribute more to the development of such policy than tinkering at the margins of our current voluntary system of employer-sponsored retirement plans. Such a system could have near universal coverage, be advance-funded, and be made invulnerable to preretirement leakage. The arguments for such a system were thoughtfully and persuasively articulated by others two decades ago.[5] The arguments, however, aroused little interest outside the scholarly community and failed to resonate politically. I don't believe that political tastes have improved dramatically since then and this article will not resurrect the case for MUPS. This article thus accepts without endorsing the continuation of the voluntary employer-sponsored pension system.

This article's assumption that the tax regime created by Subchapter D has a broadly accepted policy justification, and that the justification is to create retirement income security for most Americans, is open to question. Some have contended, for example, that the tax regime is justified because it introduces an important consumption tax element into the federal tax system, partly correcting the income tax's arguable bias against saving.[6] Others have suggested that Subchapter D is justified because it stimulates capital formation. Still others have argued that Subchapter D needs no external policy justification because it is simply a normative structural accommodation of our tax laws to the realities of deferred compensation arrangements.[7] But the orthodox view, and the view accepted in this article, is that Subchapter D generates substantial tax expenditures, which are justified to the extent they create substantial retirement wealth for most working Americans.[8] This article is written primarily for

4. PRESIDENT'S COMM. ON PENSION POL'Y, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY 42-43 (1981).

5. *See* Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419 (1983) (supporting a mandatory universal pension system, or "MUPS," as it came to be called).

6. *See generally* RICHARD A. IPPOLITO, AN ECONOMIC APPRAISAL OF PENSION TAX POLICY IN THE UNITED STATES (1990).

7. *See, e.g.*, Robert R. Frie & James G. Archer, *Taxation and Regulation of Pension Plans Under the Internal Revenue Code*, 1967 U. ILL. L.F. 691, 692 (1967); Edward A. Zalinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315, 316 (1988)

8. *See, e.g.*, Peter Orszag & Norman Stein, *Cross-Tested Defined Contributions: A Response to Professor Zelinsky*, 49 BUFF. L. REV. 629, 648-50 (2001); Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POL'Y 225 (1991). *But see* Edward Zelinsky, *Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein*, 9 AM. J. TAX POL'Y 257 (1991).

those who, like myself, accept this view of the favorable tax treatment of qualified retirement plans. This article is not an attempt to convert those who reject this view, but merely to outline some suggestions to correlate better the design of Subchapter D and related statutes with the orthodox justification for the tax regime created by it.

In addition to this introduction, the article has five short preliminary sections that present basic concepts and work through some ideas that are germane to my thinking about reform of the regulatory provisions governing deferred compensation, and a final section describing my suggestions for tax-related changes to that system. Readers experienced with qualified plans are invited to skim or skip entirely the preliminary sections.

The first preliminary section describes the Subchapter D tax regime and how its design is thought to advance retirement income security for working people who would not otherwise save adequately for retirement. The second section describes some rationales for having a voluntary employer-based, tax-advantaged deferred compensation system. The third section describes the basic types of deferred compensation arrangements: defined contribution, defined benefit, profit sharing, pension hybrid, and employee stock ownership plans. The fourth section briefly discusses the non-tax federal statutory provisions regulating deferred compensation and argues that the tax provisions and non-tax provisions should be regarded as a single regulatory entity. And the fifth preliminary section describes the basic regulatory paradox for a voluntary deferred compensation system: too much regulation may result in too few employers sponsoring plans and too little regulation may result in a system that fails to provide an aggregate amount of retirement security that justifies the $100 billion cost of the associated tax benefits.

The concluding section explores recommendations for changes to the Internal Revenue Code. Some of these changes are technical and some conceptual. Most of the recommendations are designed to improve the efficiency of the tax expenditure, particularly by increasing participation rates and benefit levels of rank-and-file workers in qualified plans. A second installment of this article will explore other, non-tax related, primarily statutory changes that would enhance the benefit security of American working men and women.

I. THE STRUCTURE OF SUBCHAPTER D AND HOW IT ADVANCES THE POLICY OF STIMULATING RETIREMENT SAVINGS

The tax treatment of qualified deferred compensation under the Internal Revenue Code is one of unreconstructed tax deferral: the employer receives a deduction for contributions to a pension or profit-sharing plan;[9] the plan pays no income tax on investment income;[10] and the employee pays no tax until she receives benefits from the plan,[11] and even then the employee can often defer taxation by "rolling over" the benefits to an individual retirement account or other qualified plan.[12]

As already noted, the orthodox view of the policy for this tax regime is that it will contribute to the overall retirement security of American workers. Because the most affluent Americans have the capacity to save for retirement on their own, without government subsidization, the primary intended beneficiaries of the tax expenditures are those least likely to save for retirement without governmental support: low- and moderate-income individuals.[13]

Given this view, the structure of the Internal Revenue Code's subsidy of retirement plans might strike us as irrational, for its architecture is one of tax deferral for plan participants. The value of the tax deferral to a given taxpayer correlates directly to that taxpayer's marginal tax rate. Thus, the Code provides the greatest retirement tax subsidy to the people with the greatest capacity to save for their own retirement, and the smallest to those with the smallest capacity. Understood another way, however, this upside-down tax subsidy is an arguably rational component of a two-part governmental strategy to enlist the private sector in building retirement savings for lower- and moderate-income workers.[14]

This strategy is, first, to make the tax benefits of qualified plans sufficiently attractive to the tax-sensitive people who own and manage businesses so that they will decide to set up plans to capture tax benefits for themselves; and, second, to require such plans, once established, to provide meaningful benefits not only to the people who set them up, but also to their moderate- and lower-income employees.[15] The Code effects the latter part of the strategy through a series of statutory provisions, most prominently the nondiscrimination rules.[16] Professor Dan Halperin has

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9. I.R.C. § 404(a) (2002).
10. I.R.C. § 501(c)(a) (2002).
11. I.R.C. § 402(a) (2002).
12. I.R.C. § 402(c) (2002).
13. *See generally* Daniel I. Halperin, *Tax Policy and Retirement Income: A Rational Model for the 21st Century, in* SEARCH FOR A NATIONAL RETIREMENT INCOME POLICY 157 (Jack L. VanDerhei ed., 1987); Michael A. Oberst. *A Perspective on the Qualified Plan Tax Subsidy*, 32 BUFF. L. REV. 603 (1983); Wolk, *supra* note 5.
14. *See supra* note 13.
15. *See, e.g.*, H.R. REP. NO. 99-313, at 578 (1986) ("For many years, the [Senate Finance Committee] has supported measures that provide tax incentives designed to encourage employers to provide retirement benefits for rank-and-file employees. It has been the committee's intention that these tax incentives, which are more valuable for individuals with high levels of income because of their marginal tax rates, should be available to employers only if their plans provide benefits for rank-and-file employees."); DAN M. MCGILL ET AL., FUNDAMENTALS OF PRIVATE PENSIONS 75 (7th ed. 1996); ALICIA MUNNELL, THE ECONOMICS OF PRIVATE PENSIONS 51 (Brookings Inst. 1982); Wolk, *supra* note 5, at 434.
16. *See* I.R.C. § 401(a)(4) (1994) (outlining rule against discrimination in benefits or contributions); I.R.C. § 410(b) (1994) (outlining rule against discrimination in coverage); *see also* Treas. Reg. § 1.401(a)-4 (1994) (interpreting I.R.C. § 401(a)(4)); Treas. Reg. § 1.410(b) (1994) (interpreting I.R.C. § 410(b)).

used a (tax) carrot and (regulatory) stick metaphor to describe the strategy.[17] Some have labeled this simply trickle-down benefits policy; it is an idea that Professor Patricia Dilley and I have elsewhere referred to as leverage.[18]

As the pension economist Alicia Munnell put it, "[t]he rationale for favorable tax treatment of qualified plans is that retirement benefits for rank-and-file employees will exist if Congress provides tax incentives that induce higher paid employees to support the establishment of employer-sponsored pension plans."[19]

The qualified plan regime has been subject to criticism.[20] Firms do respond to the tax incentives by establishing plans. But firms often don't want to cover lower- and moderate-income employees because those employees, at least as a group, do not value deferred compensation at its cost to the firm.[21] Accordingly, some employers who participate in the system play a game of statutory limbo, bending under the regulatory stick by manipulating the complexities of the nondiscrimination rules to minimize benefits for rank-and-file employees, while maximizing benefits for the highly compensated who will save even without governmental subsidization.[22] Moreover, many employers simply do not respond to the incentives and fail to sponsor pension plans.[23] Thus, the system is both over-inclusive in that it provides benefits for those who can save for their own retirement without governmental incentive, and under-inclusive because it fails to cover many low- and moderate-income workers and often pays such employees trivial benefits, if any at all.

The societal goal of facilitating broad access to private retirement benefits depends not only on plans covering rank-and-file employees, but also on a plan having features that are consistent with the provision of

17. *See* Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income? Should It Continue?*, 49 TAX L. REV. 1, 7 (1993); *see also* Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063, 1141 (1997).

18. *See* Patricia E. Dilley & Norman P. Stein, *Leverage, Linkage and Leakage: Problems with the Private Pension System and How They Should Inform the Social Security Reform Debate*, 29 WASH. & LEE L. REV. 289 (2001); *see also* Norman P. Stein, *Of Carrots and Stick: The Paring Down of the Qualified-Plan Paradigm*, *in* 1999 A.L.I.-A.B.A. PENSION POLICY CONFERENCE: ERISA AFTER 25 YEARS 193, 195.

19. MUNNELL, *supra* note 15, at 51.

20. *See, e.g.*, Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790, 806 (1988); Halperin, *supra* note 13; Wolk, *supra* note 5; Oberst, *supra* note 13.

21. *See supra* note 20.

22. *See* Wolk, *supra* note 5.

23. The failure to sponsor plans is primarily a small employer phenomena. About 75% of individuals working for small firms—those with fewer than 100 employees—work for firms that do not sponsor pension plans. An annual survey conducted by the Employee Benefits Research Institute shows that the primary reasons that small firms fail to sponsor plans are that business revenue is too uncertain and that employees would rather be paid cash wages. EMPLOYEE BENEFITS RESEARCH INSTITUTE, THE 2001 SMALL EMPLOYER RETIREMENT SURVEY: SUMMARY OF FINDINGS (2001), *available at* http://www.ebri.org.sers/2002/02sersf1.pdf (last visited Feb. 5, 2003).

retirement security. Thus, the Internal Revenue Code also includes an array of provisions designed to make sure a plan in fact delivers retirement benefits to its participants. For example, the Internal Revenue Code mandates that plans satisfy minimum vesting requirements and include other protections against benefit forfeiture,[24] include protections for spouses of participants,[25] and reduce the ability of a participant to draw down plan benefits prior to retirement.[26] The Internal Revenue Code also requires employers to fund retirement benefits adequately[27] and imposes penalty taxes on employers who convert the assets of a plan for their own use.[28]

Finally, if the principal societal objective underlying the tax expenditure for qualified plans is to create retirement security for workers unlikely to accumulate adequate retirement savings on their own, then we also might expect the Internal Revenue Code to limit the benefits of those who are able to save adequately on their own. The amount of benefits that such individuals accumulate under a qualified plan should be limited to the minimum necessary to create adequate incentive for employers to establish plans. The Internal Revenue Code reflects this insight by limiting annual contributions to defined contribution plans[29] and limiting the size of a retirement annuity from defined benefit plans.[30]

II. SOME THOUGHTS ON AN EMPLOYER-BASED RETIREMENT PLAN SYSTEM

In the introduction to this article I confessed to doubt about the efficacy of a government-subsidized, voluntary, employer-based retirement system, but I also indicated that I accept it as politically stable. In thinking about what changes in such a system would contribute to the nation's overall retirement policy, it might help to understand some of the arguments for an employer-based system.

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24. I.R.C. § 411 (2002).
25. I.R.C. § 417 (2002).
26. Treas. Reg. § 401-1(b) (as amended in 1976); I.R.C. § 72(n) (2002) (imposing a penalty tax on withdrawals prior to the year in which an individual attains age 70.5).
27. I.R.C. § 412 (2002).
28. I.R.C. § 4975 (2002).
29. I.R.C. § 415(c) (2002).
30. I.R.C. § 415(b) (2002). *See, e.g.*, H.R. Rep. No. 93-807, at 35 (1974); 2 Dep't of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth: General Explanation of the Treasury Dep't Proposals 346, 350 (1984). The view was expressed by Senator Russell Long on the floor of the Senate:

> [Section 415] makes the tax laws regarding pension plans fairer by limiting the amount of the contributions or benefits that can be provided to any individual under such a plan. The fact that present law does not provide such specific limitations has made it possible for extremely large contributions and benefits to be made under qualified plans for some highly paid individuals. While there is, of course, no objection to large retirement benefits in themselves, it is not appropriate to finance extremely large benefits in part at public expense through the use of special tax treatment.

120 Cong. Rec. S29,946 (1974) (statement of Sen. Long).

One argument is simply that the employer-based system is in place and works well for many of those who participate in it; dismantling the system would have cost for those who now benefit from it. Moreover, the nation has a large investment in the infrastructure of employer plans and dismantling it in favor of a new mandatory universal pension system would impose transition costs, both on the demolition and the construction side. It would also create difficult political issues regarding the status of amounts accumulated in the employer-based system and the continuation of tax benefits accorded to participants in state and local governmental plans. In other words, our retirement system—with close to a century of dependence on employer-sponsored deferred compensation—is, to a certain extent, path dependent and change to another system would carry costs and consequences, including, no doubt, unintended ones.

There are also affirmative reasons for building a system around employer-sponsored plans. Compared to a governmental agency, employers subject to fiduciary obligations of the sort imposed by ERISA[31] might prove to be the superior agent for plan participants in choosing plan investments or investment options.[32] Employers might be able to design retirement plans to effect the particular retirement strategies appropriate to their workforce. Employers are also able to communicate with their employees on a regular, and often personal, basis—something that a government-managed universal plan might not be able to do as well. Finally, and perhaps most important, a firm can design a retirement plan in ways that the firm perceives will improve productivity or help achieve other firm objectives. For example, a firm can design a plan whose benefit and vesting structures bond employees to the firm and retain experienced employees.[33] A firm can also design a plan to encourage, or discourage, retirement at certain ages.[34] To the extent the firm is willing to pay for the increased productivity, it is plausible that retirement plans actually increase employee aggregate welfare over what it would be in a world without employer-sponsored pension plans.

III. PLAN TYPOLOGY

Qualified deferred compensation plans are typed in a variety of ways. In this section, I will describe first the distinction between defined benefit and defined contribution plans, then the distinction between pension and profit-sharing plans, then a group of plans that exhibit some features of defined benefit plans and some features of defined contribution plans. The latter are commonly referred to as hybrid plans, although that is in some senses a misnomer, since a plan is, both under the Internal Revenue Code and ERISA, either defined benefit or defined contribution. Finally,

31. *See, e.g.*, ERISA §§ 401-408, 29 U.S.C. §§ 1101-1108 (1999).
32. *See generally* JOHN LANGBEIN & BRUCE WOLK, PENSION AND EMPLOYEE BENEFIT LAW 32 (3d ed. 1999).
33. *Id.* at 30-32.
34. *Id.* at 32.

we will look at ESOPs, which are plans designed to invest primarily in securities of the plan sponsor.

A. Defined Contribution and Defined Benefit Plans

1. *Basic Descriptions*

The defined contribution plan and the defined benefit plan are the chocolate and vanilla of plan types. A defined contribution plan, referred to in Title I of ERISA as an "individual account plan,"[35] is a plan in which each employee has, in effect, an individual investment account. In such a plan, the amount that the employer will contribute to the plan as a whole, and how that amount will be allocated among the employees, is defined—hence the name defined contribution.[36] In traditional defined contribution plans, the allocation of plan contributions to employees, and sometimes the contribution obligation itself, is keyed largely to relative employee compensation.

In contrast, employees have no individual account in a defined benefit plan; instead, they have from the plan a promise of the benefit they will be paid when they retire.[37] In effect, the plan defines the benefit, not the contribution.

The normal form of benefit under a defined benefit plan, which all such plans must offer, is an annuity commencing at the plan's normal retirement age.[38] Some common models of defined benefit formulas are final pay and years of service (for example, 1% of final pay multiplied by years of service); career average pay and years of service (for example, 1% of average pay over an employee's career); and a unit-based dollar and service formula (for example, $100 per month multiplied by years of service).[39] In addition to the normal form of benefit, a plan may provide participants an option to select alternative benefits (also defined by the plan), such as a lump sum distribution, an early retirement benefit, or a reduced annuity with survivor benefits.[40]

2. *Funding of Defined Benefit Plan*

The successful funding of a defined benefit plan depends upon a simple algebraic formula: the employer contributions, plus compounded interest thereon and less plan expenses, must equal the plan's benefit obligations

35. ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2) (1999) (referring to individual account plan); ERISA § 3(34), 29 U.S.C. § 1002(34) (defining individual account plan).

36. Section 401(k) plans are the most widely used type of defined contribution plan. *See, e.g.*, Profit Sharing/401k Council of America, Profit Sharing & 401(k) Facts, *available at* http://www.psca.org/facts.html (last visited Feb. 5, 2003).

37. ERISA § 3(35), 29 U.S.C. § 1002(35) (1999).

38. I.R.C. § 411(a)(7) (2002).

39. Everett T. Allen, Jr. et al., Pension Planning: Pension, Profit-Sharing, and Other Deferred Compensation Plans 230-33 (9th ed. 2003).

40. *Id.* at 215-24.

as they mature.[41] The Internal Revenue Code[42] and Title I of ERISA,[43] which has parallel funding requirements, allow the employer a good degree of flexibility in determining the timing of plan contributions. The size of an employer's annual contribution to a plan is a function of the plan's actuarial cost method and actuarial assumptions.[44]

Actuarial assumptions are guesses about the future for predicting the cost of future benefits or the growth of plan assets.[45] Actuarial cost methods assign the anticipated cost of projected plan benefits to particular years during the plan's expected life.[46] The specific cost assigned to a plan year is referred to as that year's normal cost.[47]

There are two basic types of actuarial cost methods: projected benefit methods and the accrued benefit method.[48] In a projected benefit method, the plan's actuary predicts the cost of all benefits that ultimately will have to be paid to current employees, and then assigns a portion of that cost to each plan year.[49] The normal cost for each plan year will equal the cost assigned to that particular year.[50] These methods are designed to produce a normal cost that will be a constant dollar amount or a constant percentage of payroll.[51]

With the second type of actuarial cost method, the accrued benefit method, the cost assigned to each year—the normal cost for the year—is equal to the present value of the incremental benefits considered to be

41. *See generally* Norman P. Stein, *Reversions from Pension Plans: History, Policies, and Prospects*, 44 TAX L. REV. 259 (1989) [hereinafter *Reversions*]. This article's description of plan funding is based on the description of funding in *Reversions*.

42. I.R.C. § 412 (2002).

43. ERISA §§ 302-305, 29 U.S.C. §§ 1082-1085 (1999 & Supp. 2002).

44. There is, unfortunately, no uniformity in the meaning and use of actuarial terminology. *See* MCGILL ET AL., *supra* note 15, at 519 ("[L]iterature contains much variety in the terms that describe actuarial concepts."); GARY I. BOREN & NORMAN P. STEIN, QUALIFIED DEFERRED COMPENSATION PLANS § 8:02 ("ERISA adopted a terminology not then in favor among actuaries, and did not define the terms.").

45. DONALD S. GRUBBS, *Funding*, *in* A.L.I.-A.B.A. COMM. ON CONTINUING PROF'L EDUC. (1978); BOREN & STEIN, *supra* note 44.

46. *See* Grubbs, *supra* note 45, at 4-5; BOREN & STEIN, *supra* note 44, § 8:01.

47. *See* Grubbs, *supra* note 45, at 10; BOREN & STEIN, *supra* note 44, § 8:04.

48. There are, in fact, more than two types of actuarial cost methods; ERISA § 3(31) specifies six acceptable methods, and a seventh has been approved by the Internal Revenue Service. Rev. Proc. 80-50, 1980-2 C.B. 816. The six methods mentioned in the statute were discussed by the Bureau of Internal Revenue as early as 1945. *See* Bureau Bulletin on Section 23(p)(1)(A), *reprinted in* Pens. & Profit Sharing (P-H) ¶ 69,6010 (pre-ERISA Law Volume). Of these methods, one is the accrued benefit method and the others are different varieties of projected benefit methods, although one of the projected benefit methods has some aspects of the accrued benefit method and has been labeled by Donald Grubbs as a hybrid method. Grubbs, *supra* note 45, at 6-7. For a lucid description of the primary actuarial methods sanctioned by ERISA, see Kirk Maldanado, *How to Select Acceptable Actuarial Methods for Defined Benefit Pension Plans*, 57 J. TAX'N 14 (1982).

49. *See* Grubbs, *supra* note 45, at 7.

50. *Id.* Some benefit liabilities may not, however, be reflected in a plan's normal cost, but may instead be amortized as a supplemental liability over a specific period of time. For example, some actuarial methods treat past-service credits as a supplemental liability rather than as a part of the plan's normal cost.

51. *See* Treas. Reg. § 1.412(c)(3)-1(b)(2)(i) (as amended in 1980) (requiring that normal cost be expressed as a level dollar amount or a level percentage of compensation).

accrued by employees during the year.[52] With a youthful workforce, this method can result in relatively small contributions in the early years of the plan's life, given the interest accumulation during the long period between contribution and retirement. Annual contributions will increase as the workforce ages and the period between contribution and retirement shortens.

In order to determine costs under an actuarial method, the plan's actuary must be able to plug into the method two factors: the cost of providing benefits and the rate at which plan assets will grow in the future. Since these numbers depend on future events, they are generally unknown. As a result, actuaries ordinarily must make certain assumptions about the future that allow them to estimate future benefit and asset growth.[53]

Two assumptions allow the actuary to estimate growth of plan assets and require little elaboration. These are the plan's predicted rate of return on investments, on the one hand, and its administrative expenses, on the other.[54] The assumptions related to estimating the cost of benefits are more numerous and more complex. They can, depending upon the plan, include employee turnover, pre- and post-retirement mortality, salary scale, and terminal annuity costs.[55]

If a plan's actuarial assumptions prove perfectly prescient, a plan should always have assets equal in value to the benefit costs that, under the plan's actuarial method, should already have been funded.[56] In a real world, however, assumptions will not be perfectly accurate and the plan will have to make a variety of actuarial adjustments for experience gain and experience loss.[57]

There are two models for conceptualizing the adequacy of the funding of a defined benefit plan. One model assumes that the plan is ongoing; the relevant query here is whether the employer has made all required contributions under the funding method used by the plan and if the contribution obligations are being properly adjusted to take into account experience gain and loss.[58] Another model assumes that the plan will terminate immediately; then the relevant inquiry is whether the plan's

52. Grubbs, *supra* note 45, at 7-9; BOREN & STEIN, *supra* note 44, § 8:07. For example, if a plan's benefits formula promised a 25-year-old employee a retirement annuity commencing at age 65 equal to years of service multiplied by $100 per month, the normal cost for the year would be an amount whose future value 40 years hence is equivalent to the value of an immediate annuity of $100.

53. BOREN & STEIN, *supra* note 44, § 8:02; Grubbs, *supra* note 45, at 5-6. I.R.C. § 412(c)(3) provides that each actuarial assumption and method "must be reasonable (taking into account the experience of the plan and reasonable expectations) or which, in the aggregate, result in a total contribution equivalent to that which would be determined if each such assumption and method were reasonable."

54. *See* BOREN & STEIN, *supra* note 44, § 8:02.

55. *Id.*

56. *Id.*

57. *See Reversions*, *supra* note 41, at 270-72.

58. *Id.* at 273-376.

assets at least equal the present value of the plan's liabilities.[59] Note that a plan which is adequately funded on an ongoing basis can be either over or underfunded on a plan termination basis.[60]

3. *Some Key Differences Between Traditional Defined Benefit and Defined Contribution Plans*

The structural distinctions between defined benefit and defined contribution plans, and variations in the manner in which the qualified-plan regulatory regime apply to the two basic plan types, produce significant practical differences for the plan sponsor and the plan participant.[61] It should be said that the design of so-called hybrid plans, which can be defined benefit plans that exhibit some defined-contribution-like characteristics, or defined contribution plans that exhibit some defined-benefit-like characteristics, can reduce, or, in some cases reverse, these practical differences. This section first discusses the differing benefit accrual patterns between traditional defined benefit and defined contribution plans, and then focuses on the practical differences between the two types of plans.

a. Comparison of Benefit Accrual Patterns in Defined Benefit and Defined Contribution Plans

In a traditional defined contribution plan, with an allocation formula pegged to a percentage of compensation, the present value of the employer's annual allocation to a participant will increase only as the participant's compensation increases. (In a world in which an employee's cash compensation is unvarying, the pattern of benefit accrual would be flat, i.e., the employee would receive the same dollar allocation to his account each year.) Moreover, in any given year, all participants with the same compensation will receive an identical account allocation.

The future value of each year's benefit allocation projected out to retirement age, is not, of course, flat. A contribution at 21 will be worth more at retirement age than a contribution at age 22 because of the greater period of interest compounding.

Benefit accruals in traditional defined benefit plans—where the retirement annuity is a percentage of cash compensation or a dollar figure—operate differently, with the present value of each year's benefit accrual larger for an older employee than a younger employee otherwise similarly situated. For example, assume a benefit formula of 2% times salary, times years of service, payable at age 65. Also assume a 21-year-old employee and a 64-year-old employee, each earning $100,000. Nominally, the benefit they earn during the year is identical: a $2,000 annuity commencing at normal retirement age. The present value of the benefit, how-

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59. *Id.*; *see also* I.R.C. § 412(l)(7) (2002) (defining plan's current liabilities, which are the liabilities the plan would have to satisfy if it terminated immediately).

60. *See Reversions*, *supra* note 41, at 273-76.

61. *See generally* LANGBEIN & WOLK, *supra* note 32, at 52-57.

ever, is markedly different, because the contribution to fund the deferred annuity for the 21-year-old has a 44-year period to earn interest, while the comparable period for the 64-year-old is one year. Assuming that the cost of a $2,000 annuity at age 65 is $22,000, the present value of the 64-year-old's benefit accrual is $20,037, and the present value of the 21-year-old's benefit is $744 (assuming an 8% discount rate and no pre-retirement mortality adjustment).

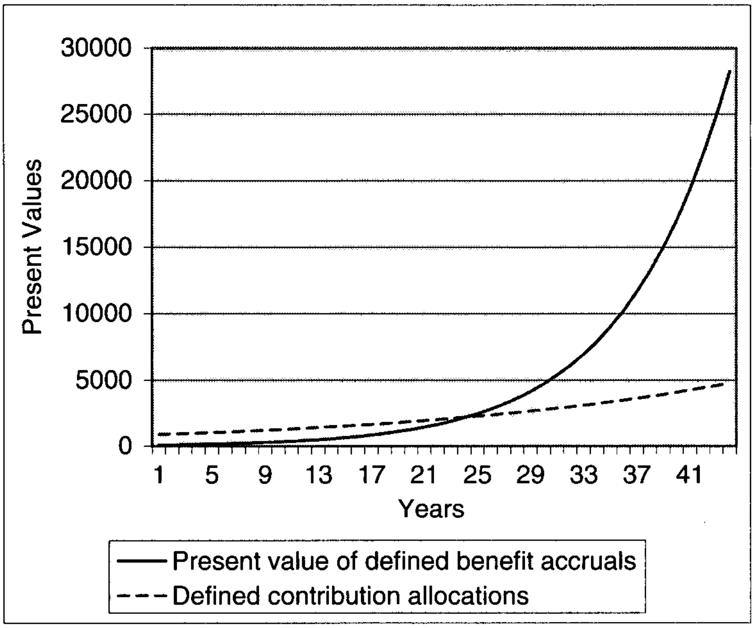
Moreover, many defined benefit plan formulas are related, in some way, to compensation during the last period of employment for the plan sponsor. In a final pay plan, where this relationship is explicit, the employee's benefit is based on final pay with the employer, typically the average of the last three year's of compensation. In such plans, a compensation increase in one year can be understood as increasing all the previous year's benefit accruals. Alternatively, and perhaps more accurately, a compensation increase's effect on the benefit can be regarded as providing a successively larger benefit accrual as compensation increases during an employee's service with the employer.

Similar effects can be observed in some plans not expressly based on final pay. In such plans, the employer may periodically, or episodically, amend the plan retroactively to adjust the benefit formula to account for changes in the cost-of-living index and/or improvements in productivity. Generally the plan sponsor limits such changes to participants in the plan as of the amendment date.

The effect of traditional defined benefit plans, then, is to backload benefits into an employee's later years of employment; a traditional defined contribution plan will have a more level rate of accrual over a participant's career. To illustrate this, compare the benefit accrual patterns of two plans—one defined benefit, one defined contribution—each designed to produce approximately $500,000 worth of benefits at age 65, for an employee who begins participation in the plan at age 21. The defined benefit plan provides a benefit equal to 1% of final pay (the average pay for the last three years of service) and the defined contribution plan an annual allocation of approximately 4.75% of compensation. Assume that at age 21 the employee is paid $20,000 and that pay will increase 4% each year. Also assume that the applicable interest rate during the employee's career is 7.5% and that a dollar of annuity at age 65 has a present value of $11. Under these facts, the present value of the annuity at age 65 has a present value of just under $503,000 and the accumulation in the defined contribution plan is also just under $503,000.[62]

A comparison of the annual contributions to the defined contribution plan and the present value (without discounting for pre-retirement mortality) of benefit accruals in the defined benefit plan appears below:

62. In determining the present value of the annuity at age 65, I used a conversion factor of 11, which reflects an interest rate of 5.85% and the use of the 94GAR mortality tables.



Because the accrual pattern in the defined benefit plan is substantially backloaded, the plan participant will earn most of his benefit in the last third of his employment. The implicit contract reflected in a defined benefit plan, then, is that long tenure with the employer will be rewarded. As a result, defined benefit plans are generally better vehicles for bonding the employee to the firm than are defined contribution plans. Defined contribution plans are generally better vehicles for more mobile employees than defined benefit plans.

b. Important Distinctions Between Defined Benefit and Defined Contribution Plans

i. Investment Risk.

In a defined contribution plan, investment risk rests on the employees, whose accounts will reflect investment gain and investment loss. In contrast, in defined benefit plans, the investment risk rests, at least nominally, on the employer, whose future plan contributions will be adjusted to reflect investment gain or loss. It should be noted, however, that the employee shares some of the investment risk in two ways. First, if the plan fails and the employer is insolvent, the Pension Benefit Guaranty Corporation, which insures benefits in defined benefit plans, does not insure all benefits.[63] Second, it is often possible for employers to mitigate investment loss by prospectively reducing or eliminating benefits, making the employees share in investment loss.

63. ERISA § 4022, 29 U.S.C. § 1322 (1999) (requiring corporations to guarantee benefits under single-employer plans).

ii. Insurance

As noted above, the Pension Benefit Guaranty Corporation insures certain benefits in defined benefit plans;[64] there are no similar governmental programs insuring benefits in defined contribution plans.[65]

iii. Defined Benefit Plans Favor Older Employees

See subsection a.

iv. Defined Benefit Plans Reward Job Longevity

See subsection a.

v. Defined Benefit Plans Can Grant Credit for Past Service

A defined benefit plan's formula can grant benefit credit for employee service prior to the time the plan was adopted.[66] Assume, for example, a company that has achieved stability after 10 years. The company adopts a defined benefit plan providing 2% of final pay, multiplied by years of service, with years of service encompassing service from the firm's origins. Note that this will generally create an immediate unfunded plan benefit liability.[67] In contrast, a defined contribution plan generally does not allow the employer to go back and contribute for years prior to the plan's creation.

vi. Defined Benefit Plans Can Retroactively Increase Benefits

Just as a defined benefit plan can be designed to give past service credit, it can also be amended to provide retroactive benefit increases. For example, the employer might change the benefit formula from 2% of final pay to 3% of final pay and make the improved formula retroactive. Again, in some cases amending a plan in such a way can create an unfunded benefit liability.[68]

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64. *See generally* ERISA §§ 401-414, 29 U.S.C. §§ 1101-1114 (1999).

65. Professor Regina Jefferson has proposed a model for insuring the risk in certain defined contribution plans. *See* Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607 (2000).

66. The regulations under I.R.C. § 401(a)(4) place limits on this practice when the effect is to favor highly compensated employee. *See* Treas. Reg. § 1.401(a)(4)-5(a) (2002).

67. The Internal Revenue Code requires for purposes of the minimum funding rules that the resulting past-service liability be amortized over a period of 30 years. I.R.C. § 412(b)(2)(B)(ii) (2002).

68. Again, the Internal Revenue Code requires for purposes of the minimum funding rules that the resulting past-service liability be amortized over a period of 30 years. I.R.C. § 412(b)(2)(B)(iii) (2002). The Internal Revenue Code requires for purposes of the minimum funding rules that the resulting past-service liability be amortized over a period of 30 years. I.R.C. § 412(b)(2)(B) (2002).

vii. Defined Benefit Plans Can Provide Incentives for Employees to Retire Early

A plan sponsor can use a defined benefit plan to encourage employees to separate from service before normal retirement age by providing a subsidy for employees who retire at certain earlier ages.[69] An employer can also amend a defined benefit plan to create an "early retirement window," in which employees are given a relatively compressed period of time to choose to retire during a "window" period in which value will be added to their benefit.[70]

viii. Ownership of Employer Stock and Employer Real Property

A defined benefit plan is prohibited from having more than 10% of its assets invested in employer securities or real property used by the employer.[71] A defined contribution plan can be designed so that it is not subject to these limits and is permitted in many circumstances to have 100% of its assets invested in employer securities or real property.[72]

ix. Defined Benefit Plans Are More Costly to Administer

Defined benefit plans are generally more costly to administer, in large part because of the need to engage the services of an actuary.

x. Surplus Plan Assets Can Revert to the Employer in a Defined Benefit Plan

An employer is permitted to recover assets in excess of the cost of the value of plan benefit liabilities on plan termination in a defined benefit plan.[73] In a defined contribution plan there generally are no "surplus" assets and the Internal Revenue Code generally does not permit the sponsor of a defined contribution plan to recover assets on plan termination.

xi. Plan Termination

ERISA, and, to a certain extent, the Internal Revenue Code heavily regulate the termination of a defined benefit plan. In some cases, where the plan is underfunded and the employer is fiscally sound, ERISA prohibits plan termination, although the employer may amend the plan to freeze benefits.[74] In contrast, there are few limitations on an employer's

69. *See, e.g.*, Kerry A. Brennan, *Early Retirement Incentives: "Golden Handshake" for Some, Age Discrimination for Others*, 54 BROOK. L. REV. 927 (1988); Lorraine A. Schmall, *Telling the Trusth About Golden Handshakes: Exit Incentives and Fiduciary Duties*, 5 EMPL. RTS. & EMPLOY. POL'Y J. 169 (2001).

70. *Id.*

71. ERISA § 407(a), 29 U.S.C. § 1107(a) (1999).

72. ERISA § 407(b), 29 U.S.C. § 1107(b) (1999).

73. *See* I.R.C. § 401(a)(4) (2002); Treas. Reg. § 1.401-2 (2002); ERISA § 4044(d), 29 U.S.C. § 1461(d) (1999).

74. ERISA § 4041(b), (c), 29 U.S.C. § 1341(b), (c) (1999).

ability to terminate a defined contribution plan.[75]

xii. Nondiscrimination Testing

The Internal Revenue Code requires that a plan not discriminate in favor of highly compensated employees in benefits or contributions. Historically, the means of testing for discrimination in a defined benefit plan was to compare the annual benefit accruals for highly and non-highly compensated employees as a percentage of compensation.[76] In contrast, in defined contribution plans the comparison was additions to the accounts of employees, again as a percentage of salary.[77] Today, however, defined benefit plans are permitted to test on a contributions basis and defined contribution plans on a benefits basis through a process called cross-testing.[78]

xiii. Section 415 Limitations

Section 415 controls the amount of tax benefit a qualified plan provides to an employee; its rationale is that the tax treatment of qualified plans is designed to allow people to save reasonable, not lavish, amounts for retirement.[79] Thus, § 415 places limits on both defined contribution and defined benefit plans.[80] The limits are designed to control the career benefit in a defined benefit plan and the annual contribution in a defined contribution plan.[81]

In the case of defined benefit plans, § 415 limits the maximum annual life annuity payable as early as age 62 (the current limitation is the lesser of 100% of compensation or $160,000).[82] In the case of defined contribution plan, § 415 limits the allocation of the employer's contribution to the lesser of 25% of compensation or $40,000.[83]

Section 415 at one time had a provision that reduced either or both of the defined benefit or defined contribution limits in cases where the employer sponsored both types of plans.[84] Congress repealed this provision, purportedly because of its complexity, in 1996 (effective in 2000).[85]

B. Pension and Profit-Sharing Plans

The Internal Revenue Code draws a distinction between pension plans, on the one hand, and profit-sharing plans, on the other. A pension plan is

75. *But see* Treas. Reg. § 1.401(a)(4)-5(b) (2002).
76. *See generally* Orszag & Stein, *supra* note 5, at 641-47.
77. *Id.*
78. *See infra* text accompanying notes 132-37.
79. *See supra* note 30.
80. I.R.C. § 415(b) places limits on defined benefit plans. I.R.C. § 415(c) (2002) (defining contribution plans).
81. *Id.*
82. I.R.C. § 415(b) (2002).
83. I.R.C. § 415(c) (2002).
84. I.R.C. § 415(e) (repealed 1996).
85. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1452, 110 Stat. 1755, 1816-17 (1996).

designed to provide a definitely determinable benefit at retirement age.[86] A profit-sharing plan is designed to permit an employer to share profits, on a deferred basis, with its employees.[87] All defined benefit plans are pension plans, but a defined contribution plan can be either a pension or profit-sharing plan, depending on its purpose and design.

There are some significant differences between pension and profit-sharing plans:

(1) Because retirement plans are designed to provide a definitely determinable benefit at retirement age, Treasury Regulations prohibit distributions to employees prior to their attainment of normal retirement age.[88] Profit-sharing plans, on the other hand, are permitted under some circumstances to make in-service distributions.[89]

(2) Pension plans must offer, as their normal form of benefit, a life annuity commencing at normal retirement age; for married participants, the normal form of benefit is a joint-and-survivor annuity.[90] A pension plan may include other forms of benefits, such as a lump sum distribution, but the spouse of a married participant must generally consent to any benefit form other than a joint-and-survivor annuity.[91] In contrast, the only provision protecting a spouse in a profit-sharing plan is that the account balance must be paid to the spouse on the participant's death, unless the spouse has consented to a different beneficiary.[92]

(3) Until the 2001 amendments to the Internal Revenue Code, employer deductions for contributions to a profit-sharing plan were limited to 15% of the compensation of participants, a limitation not applicable to pension plans.[93]

C. Hybrid Plans

Defined contribution plans can be designed to have some of the features of defined benefit plans and defined benefit plans can be designed to have some of the features of defined contribution plans. Until recently, the classic hybrid plan was the "target benefit plan," a defined contribution pension plan in which the employer funds a "target benefit" for each employee under a defined-benefit-type formula and then funds it using actuarial assumptions and factors stated in the plan.[94] As in any defined contribution plan, employer contributions are allocated to the accounts of employees, as are the plan's actual investment gains and

86. Treas. Reg. § 1.401-1(a)(2)(i) & (b)(1)(i) (as amended in 1976).
87. Treas. Reg. § 1.401-1(a)(2)(ii) & (b)(1)(ii) (as amended in 1976).
88. *See* Rev. Rul. 74-254, 1974-1 C.B. 91.
89. *See* Rev. Rul. 68-24, 1968-1 C.B. 150; Rev. Rul. 71-224, 1971-1 C.B. 124.
90. I.R.C. §§ 401(a)(11), 417 (2002).
91. *Id.*
92. I.R.C. § 401(a)(11)(B)(iii) (2002).
93. I.R.C. § 404(a)(3) (2001). All defined contribution plans are now subject to a general deduction limit of 25% of participant compensation. I.R.C. § 404(a)(3)(i)(2) and (v).
94. *See* Boren & Stein, *supra* note 44, § 1:09.

losses.[95] The key difference between a target benefit plan and a true defined benefit plan is that in a target benefit plan the employer does not adjust contributions to reflect better- or worse-than-anticipated investment performance; the employee's benefit is not the target benefit but the account balance at retirement.[96]

In the last decade, two additional "hybrid" plans have come into prominence: the cash-balance plan and the age-weighted defined contribution plan.[97]

1. Cash-Balance Plan

A cash-balance plan is a defined benefit in which the benefit is determined with respect to a hypothetical account balance.[98] Each employee has such an account (although no actual dollars are allocated to it) and the defined benefit to which the employee is entitled, and which the employer funds, is the account balance. The account balance is determined under a plan formula, which describes how the balance grows: a typical cash-balance plan has an annual pay credit, generally expressed as a percentage of the employee's compensation for the year in question, and an interest credit on the account balance, which may be expressed as a flat interest rate or be referenced to some index (for example, the 30-year treasury bond rate, a stock index, etc.). The IRS has taken the position that for the plan to satisfy the Internal Revenue Code's anti-backloading requirements,[99] the interest credit must continue until normal retirement age, even if the employee separates from service.[100]

Under the statute, the normal form of benefit accruing under a defined benefit plan is a life annuity,[101] so cash-balance plans must define the normal retirement benefit as a life annuity whose present value is the

95. *Id.*

96. *Id.*

97. In some senses, a multiemployer plan, at least pre-ERISA multiemployer plans, could be considered a hybrid. A multiemployer pension plan is a plan negotiated by a union to which a number of employers and their employees participate. *See generally* LANGBEIN & WOLK, *supra* note 32, at 62-66. Typically, the collective bargaining agreement specifies a contribution rate and the trustees of the plan design the benefit structure. Prior to ERISA, such plans commonly provided that participating employers had no contribution obligation beyond that specified in the collective bargaining agreement and thus from the employer perspective the plan had some of the features of a defined contribution plan. *See generally* Nachman v. Pension Benefit Guaranty Corp., 446 U.S. 359 (1980) (holding that multiemployer plans are defined benefit plans under ERISA).

98. There has been considerable writing on cash-balance plans, both in the academic literature and the popular press, many of whose titles play on the word "balance." *See, e.g.*, Regina T. Jefferson, *Striking a Balance in the Cash Balance Plan Debate*, 49 BUFF. L. REV. 513 (2001); Alvin D. Lurie, *The Enigma Variations: Striking a Balance for the Cash Balance Design*, 58 N.Y.U. INST. FED. TAX'N ¶ 8 (2000); *Retirement in the Balance*, CONTINGENCIES (Sept./Oct. 1999) (including four articles on cash balance plans: Editor, *What are Cash Balance Plans*; Larry Sher, *A Workable Alternative to Defined Benefit Plans*; Norman P. Stein, *Some Serious Questions About Cash Balance Plans*; David M. Straus, *There's No Need to Retire Traditional Pensions*).

99. I.R.C. § 411(b) (2002).

100. *See* I.R.S. Notice 96-8, 1996-1 C.B. 359.

101. I.R.C. § 401(a)(7) (2002).

equivalent of the hypothetical account balance at retirement age. In reality, most cash-balance plans are designed with the expectation that the vast majority of participants will elect to take their benefit in an optional lump sum form, which is equal to the hypothetical account balance. In effect, a cash-balance plan has the look-and-feel of a defined contribution plan to the participant, but it is in fact a true defined benefit plan. As such, it can be over- or underfunded, is insured by the PBGC, must offer a life annuity as the normal form of benefit, and is subject to a number of rules regulating defined benefit but not defined contribution plans.

By and large, plan sponsors of cash balance plans have converted existing traditional defined benefit plans into cash balance plans (by amending the plan's benefit formula on a prospective basis) rather than creating a new plan from scratch.[102] Because traditional defined benefit plans are more valuable to older employees than a defined contribution plan, and because cash-balance plans mimic the benefit accrual pattern of defined contribution plans—older workers generally lose a portion of their anticipated future benefits after the traditional defined benefit plan is converted into a cash-balance format. Some have argued that such conversions, and the resulting reduction of future accruals for older employees, break the implicit contract between the employer and the employee represented by a traditional defined benefit plan: long job tenures will be rewarded with significant benefit accruals in the last part of an employee's service with the employer.[103]

2. *Age-Weighted Defined Contribution Plans*

Age-weighted profit-sharing plans are in most structural particulars run-of-the-mill defined contribution plans. Where they differ from traditional defined contribution plans is in the manner in which allocations are made to participant accounts. In traditional plans, the annual allocation to participant accounts are proportionate to compensation. Thus, two employees of different ages receiving the same compensation would receive the same dollar allocation.[104]

Age-weighted profit-sharing plans depart from this model in that allocations are based partly on a participant's age.[105] For example, a 55-year-

102. *See* Stein, *supra* note 98; *but see* Letter from James F. Sanft to Editor, CONTINGENCIES (Jan./Feb. 2000) (noting that the Lutheran Church Missouri Synod adopted a cash balance plan from scratch). Since the publication of the original CONTINGENCIES article, I have become aware of a handful of other cash balance plans adopted from scratch. But although many people have taken issue with points raised in the original article, no one has argued that the vast majority of cash balance plans have not resulted from conversions of existing plans.

103. *See* Jefferson, *supra* note 98; Stein, *supra* note 98.

104. There were always some defined contribution plans that did not allocate contributions solely on the basis of relative participant compensation. The text earlier mentioned target benefit plans, where contributions are weighted toward age.

105. For a description of age-weighted defined contribution plans and their planning possibilities, see PETER A. CHRISTENSEN & MARJORIE MARTIN, A COMPLETE GUIDE TO AGE-WEIGHTED DEFINED CONTRIBUTION PLANS (RIA 1992). *Compare* Edward A. Zelinsky, *Is Cross-Testing a Mistake?: Cash Balance Plans, New Comparability Formulas and the*

old employee might be allocated 25% of pay, while a 25-year-old lower-paid employee would be allocated 3% of final pay.[106] These plans can be attractive to small and medium-sized businesses where the firm is owned primarily by older individuals.

Such an allocation scheme raises a nondiscrimination concern under I.R.C. § 401(a)(4), since highly compensated employees, if they are older than other employees, will receive disproportionately high annual allocations. The Internal Revenue Code, however, permits plans to be cross-tested.[107] Under cross-testing, defined contribution allocations are tested on a benefits basis, i.e., the allocation is converted into an equivalent retirement annuity at normal retirement age. In effect, the allocation is tested for compliance with § 401(a)(4) on the future value of the contribution as of the employee's attainment of retirement age. Thus, age-weighted profit-sharing plans can satisfy the nondiscrimination rules.

In recent years, the design of age-weighted profit-sharing plans has evolved. Using an assortment of aggressive approaches to nondiscrimination testing, pension consultants have created a type of plan—often known as new comparability plans—that permit firms to provide age-weighted benefits only to the most highly-paid of their employees, while denying such benefits to older rank-and-file employees.[108] In early 2002, the Department of Treasury promulgated final regulations placing some limits on the use of some new comparability plans.[109]

D. Employee Stock Ownership Plans ("ESOPs")

An Employee Stock Ownership Plan is a profit-sharing plan designed to invest primarily in qualifying employer securities.[110] ESOPs are provided with several advantages under the Internal Revenue Code and ERISA.[111] Among the tax advantages of an ESOP are the following:

1. ESOPs can be used as a favorable means of corporate finance. The ESOP can borrow money to purchase employer stock on the market, but more typically from the firm or from firm insiders (due to an exception from the prohibited transaction rules).[112] The loan is secured by the stock, which is allocated to participant accounts as

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Incoherence of the Nondiscrimination Norm, 49 BUFF. L. REV. 575 (2001) (arguing against restrictions for age-weighted defined contribution plans) *with* Orszag & Stein, *supra* note 8.

106. *Id.* This assumes that the plan is top-heavy and must provide a 3% minimum contribution to non-key employees. *See* Orszag & Stein, *supra* note 8, at 644.

107. Treas. Reg. § 1.401(a)(4)-(8) (as amended in 2001).

108. *See* Zelinsky, *supra* note 105, at 587-92; Orszag & Stein, *supra* note 8, at 629-32, 641-47.

109. Treas. Reg. § 1.401(a)(4)-8(b) (2002); Rev. Rul. 2001-30, 2001-29 I.R.B. 46.

110. I.R.C. § 4975(e)(7) (2002). The National Center for Employee Ownership has published a clear description of ESOPs *at* http://www.nceo.org/library/overview.html#esops (last visited Feb. 5, 2003).

111. The ESOP Association claims credit for many of these tax benefits. *See Legislative History & Victories of The ESOP Association—The Only National Voice for ESOPs*, *at* http://www.esopassociation.org/gov/victories.html (last visited Feb. 5, 2003).

112. I.R.C. § 4875(d)(3) (2002); ERISA § 408 (b)(3), 29 U.S.C. § 1108 (1999 & Supp. 2002).

the loan is repaid. The loan is generally repaid with employer contributions to the ESOP, which are deductible. In effect, the firm is able to deduct not only interest payments on the loan, as with a conventional loan, but also the principal payments.[113]

2. The employer gets an immediate deduction for stock contributions to an ESOP, even though the stock is treasury stock and has no immediate cash cost to the employer.[114]
3. Dividends paid by the firm to an ESOP are deductible to the firm if they are paid to plan participants, in cash; if participants are given an opportunity to receive their allocable share in cash from the plan within 90 days of payment; if the participant can elect to take the dividend in cash or reinvest it in employer securities; or if the dividends are used to repay an ESOP loan.[115]
4. There is a partial exclusion from the estate tax for shares sold by an estate to an ESOP.[116]
5. In certain circumstances, a person selling shares of employer stock to an ESOP can avoid immediate taxation by using the sales proceeds to purchase replacement securities, allowing the seller to diversify his holdings without tax consequence.[117]
6. An ESOP can be set up as a shareholder in an S Corporation.[118] (An ESOP of this sort is known, colloquially, as an S-ESOP.) Since neither the S Corporation nor the ESOP are subject to income tax, business income from such S Corporations can, essentially, be removed from the tax base.[119]

IV. RELATIONSHIP BETWEEN TITLE I OF ERISA AND THE INTERNAL REVENUE CODE

In 1974, Congress enacted ERISA, a culmination of a more than decade-long consideration of the nation's voluntary-sector pension system. ERISA has three substantive titles: Title I, which amended the nation's labor laws by adding both substantive pension protections and general fiduciary requirements; Title II, which amended the Internal Revenue Code's provisions regulating the tax treatment of deferred compensation plans; and Title IV, which created the Pension Benefit Guaranty Corporation. Although the three titles are administered by separate agencies,

113. LANGBEIN & WOLK, *supra* note 32, at 48-49.
114. This is true in general when an employee is compensated with stock. *See* I.R.C. § 83(h).
115. I.R.C. § 404(k) (2002).
116. I.R.C. § 2057 (2002).
117. I.R.C. § 1042 (2002).
118. I.R.C. § 1361(c)(6) (2002). *But see* I.R.C. § 409(p) (2002) (providing for deemed distribution of certain allocations of subchapter S stock to certain participants in S-ESOPs).
119. For a description of the income-tax-defeating benefits of S-ESOPs, see the Ohio Employee Ownership Center at Kent University, *Subchapter S ESOPs—Opportunity & Controversy*, *at* http://dept.kent.edu/oeoc/PublicationsResearch/Winter1997-8/SubchapterSWin1997-8.html (last updated Feb. 5, 2003).

they are profitably understood as addressing a series of related concerns with the nation's pension plans, concerns that largely orbited around a central object: providing meaningful protections to the benefit expectations of men and women who participate in employee benefit plans. This is, in my view, the unifying purpose of the statute as a whole. (It should be said that Congress considered creating a single entity to regulate employee benefits, but rejected this approach for reasons that are probably best understood as reflecting jurisdictional conflict among both the administrative agencies and Congressional committees.)[120]

Thus, the connective tissue between the three titles is the overarching theme of protecting employee and beneficiary rights in employee benefit plans. Indeed, many of the amendments that Title II made to the Internal Revenue Code precisely (or in a few cases virtually or largely) track provisions in Title I of ERISA: the vesting provisions,[121] the funding provisions,[122] the benefit accrual provisions,[123] the spousal protection provisions,[124] the anti-alienation provisions,[125] and the prohibited transaction provisions[126] are virtually the same in Titles I and II. These parallel set of provisions can be understood as ensuring that private-sector retirement plans (i) include features to help the plan meet participant and governmental expectations for retirement plans; and (ii) are administered by individuals and entities subject to strict rules of fiduciary conduct. Title IV provides the additional protection of benefit insurance for participants in defined benefit plans.

The different titles of ERISA, though bound by the common theme of protecting plan participants, have somewhat differing orientation, focus, and function. The Internal Revenue Code, after all, is a taxing statute, whose primary purpose is the collection of revenue. The substantive pension provisions that the Internal Revenue Code shares with ERISA are, from the vantage of tax policy, designed to extend the qualified plan tax expenditures only to societally useful retirement plans. Plans that do not meet the requirements of these provisions either lose their tax qualification or subject the employer and certain third parties to penalty taxes. It should also be said that the Internal Revenue Service enforces the provisions of the Internal Revenue Code and individual participants generally cannot compel a plan, plan sponsor, or plan administrator to comply; nor can individual participants generally compel the IRS to enforce its provisions. Participants can, however, bring civil actions to enforce Title I of

120. *See* Michael S. Gordon, *Overview: Why Was ERISA Enacted?*, *in* U.S. SENATE, SPECIAL COMM. ON AGING, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: THE FIRST DECADE 6 (1984), *reprinted in* LANGBEIN & WOLK, *supra* note 32, at 67, 73.

121. I.R.C. § 411 (2002); ERISA § 203, 29 U.S.C. § 1053 (Supp. 2003).

122. I.R.C. § 412 (2002); ERISA §§ 301-305, 29 U.S.C. §§ 1081-1085 (1999).

123. I.R.C. § 411(b) (2002); ERISA § 204, 29 U.S.C. § 1054 (Supp. 2003).

124. I.R.C. §§ 401(a)(11), 417 (2002); ERISA §§ 205, 206, 29 U.S.C. § 1055, 1056 (1999 & Supp. 2003).

125. I.R.C. § 401(a)(13) (2002); ERISA § 206(d), 29 U.S.C. § 1056(d) (1999).

126. I.R.C. § 4975 (2002); ERISA §§ 406-408, 29 U.S.C. §§ 1106-1108 (1999).

ERISA, including Title I provisions that also appear in the Internal Revenue Code.

The provisions that overlap Title I of ERISA and the Internal Revenue Code are concerned with plan administration and substantive minimum protective standards for participants and their beneficiaries. But the Internal Revenue Code, whose pension provisions are designed to reserve tax benefits to those plans that are societally useful, has other goals as well, namely, creating retirement savings for that segment of the population that might not be expected to save adequately for retirement on its own. As noted earlier, our system does this by first encouraging firms to adopt plans with tax incentives directed toward owners and highly-paid employees, and second, by requiring plans once adopted to cover less highly compensated employees through the nondiscrimination rules.[127] The Internal Revenue Code thus effects a calibration of the amount of the tax subsidy against the effectiveness of the nondiscrimination rules at providing benefits for rank-and-file workers. As Professor Wolk noted in 1983, if the nondiscrimination rules are too unyielding, many employers will not adopt plans at all despite the tax subsidy; but if they are too weak, firms will adopt plans that provide too little retirement security for rank-and-file employees to justify the qualified plan tax expenditure.[128] In addition, the tax subsidy for the affluent should be limited to the amount needed to induce the desired behavior: plan formation in a tax regime that requires compliance with meaningful nondiscrimination rules. The numerous provisions in the Internal Revenue Code that reflect the Congressional calibration of incentive and regulation are administered by the Internal Revenue Service; unlike the Code provisions that also appear in ERISA, they are not generally privately enforceable by plan participants.

Nevertheless, the whole of ERISA (Titles I, II, and III) can be seen as a single expression of government policy: encouraging plan formation through tax incentives and then ensuring that the plans in fact yield an adequate and reliable degree of retirement security through various forms of regulation.

V. THE PARADOX OF A VOLUNTARY BUT REGULATED RETIREMENT SYSTEM

In the preceding section we considered the tension between the goal of requiring plans to provide benefits to non-highly compensated employees through the nondiscrimination rules with the goal of encouraging more firms to adopt plans in the first place. If we accept the notion, as suggested in the last paragraph of the preceding section, that we should consider ERISA and the Internal Revenue Code as embodying a unified national retirement policy of using the tax system to encourage plan for-

127. *See supra* Section I.
128. *See* Wolk, *supra* note 5.

mation and regulation to force those plans to yield meaningful amounts of retirement security, then similar tensions are visible throughout ERISA. The greater the degree of regulation to protect employees, the greater the direct and indirect costs to the firm sponsoring the plan. The greater these costs, the lower the size of benefits and the rate of plan formation. This allows business (and labor organizations when they sponsor plans) to argue within the legitimate framework of benefits debate that too much protection of employees, too much paternalism, and too much restriction on plan design is undesirable because it will cool the ardor to create plans.

In a system in which there are no mandates for employers to establish plans for their employees, all benefit issues ultimately come down to striking the proper balance between regulating the design of plans and the behavior of those who administer them to accomplish societal goals, and not discouraging firms from adopting plans in the first place.

VI. ALPHABET SOUP OF PENSION REFORM: 26 PROPOSED MODIFICATIONS TO THE INTERNAL REVENUE CODE AND ERISA

Our nation does not have an entirely rational retirement policy. The goal of providing meaningful and universal retirement security for working people is not plausibly attainable through a voluntary but regulated pension system. But this article is not a brief in favor of a different model for increasing retirement income security—one that would presumably impose employer mandates, adopt an enhanced public retirement system, or some combination of the two. Instead, the article is, in essence, a list of suggested statutory changes for making the voluntary system better effect the purpose of the tax expenditures employer plans currently enjoy.

The orthodox, mainstream view of the tax expenditure's purpose, as I earlier observed, is that it will enhance the retirement security of people who otherwise would not have saved adequately for their retirement. It is from this perspective that I have created the following list of desirable amendments to the Internal Revenue Code. In a second article, I will outline other primarily non-tax amendments to ERISA.

I have divided my suggestions here into two categories: (1) improving coverage and benefit levels for lower- and middle-income employees; and (2) increasing the efficiency of the tax incentives for qualified plans. There is considerable overlap between these two categories and the inclusion of some of my suggestions changes in one category rather than the other is to a certain extent arbitrary.

I recognize that some, if not many, of my suggested changes are unlikely to command broad political support, especially given that some of them look to repeal changes that were only made in 2001, and that some of my suggestions can be legitimately opposed within the legitimate framework of benefits policy debate because they might discourage plan formation and/or result in firms reducing benefits in existing plans. But as I have observed elsewhere, the primary effect of the last decade of legislation, regulation, and judicial decision has been to loosen protective regulation and increase tax incentives without appreciably increasing benefits for rank-and-file workers.[129] Indeed, coverage rates experienced a significant decline in the last year.[130] The balance between regulation and incentive needs recalibration and enacting some of the following suggestions would help right the current law's tilt against employee protection and toward plan sponsor autonomy.[131]

1. Improving coverage and benefit levels for lower- and middle-income employees

The first four suggestions (a-d) relate to the use of plans that favor older employees. Small firms sometimes use these plans to provide substantial benefits to older key employees while providing substantially smaller benefits (as a percentage of pay) to rank-and-file employees.[132] The second and third suggestions are offered as alternatives to the first suggested change, which is the elimination of age-weighted profit-sharing plans.

a. Eliminate Age-Weighted Defined Contribution Plans.

There is both a statutory and policy argument for permitting age-weighted profit-sharing plans. The statutory argument, which is reflected in treasury regulations promulgated in the early 1990s, is that § 401(a)(4) requires that plans be nondiscriminatory in either benefits or contributions.[133] Although for most of its history § 401(a)(4) was generally understood as applying a benefits test to most defined benefit plans and a contributions test for most defined contribution plans, the present regulations now make clear that either type of plan can be tested under either approach.[134] The policy argument is essentially this: if a firm wants to favor older employees, it should not be forced into using a defined benefit plan format.[135]

The problem with age-weighted profit-sharing plans is that small firms sometimes adopt them for the purpose of effecting stunning disparities between benefits of highly compensated and non-highly compensated

129. *See* Dilley & Stein, *supra* note 18.
130. Congressional Research Service, Pension and Retirement Savings Plans: Sponsorship and Participation (Oct. 7, 2002) (plan participation among full-time workers ages 25-64 fell from 57.7% in 2000 to 55.8% in 2002), *available at* http://benefitslink.com/articles/rl30122.pdf.
131. *See generally* Colleen E. Medill, *Targeted Pension Reform*, 27 J. LEGIS. 1 (2001) (arguing that concerns about increased regulation adversely affecting employer willingness to sponsor plans are overstated).
132. *See supra* text accompanying notes 61-63.
133. *See* Zelinsky, *supra* note 8, at 580-81.
134. *See* Orszag & Stein, *supra* note 8, at 641-42.
135. *See generally* Zelinksy, *supra* note 8.

plan participants.[136] It is true that similar degrees of discrimination can be accomplished in defined benefit plans, but smaller firms sometimes eschew defined benefit plans because of their high administrative costs and thus do not have, as a practical matter, the ability to discriminate without age-weighted profit-sharing plans. In addition, defined benefit plans are different from defined contribution plans because they facilitate various types of risk-shifting between the firm and plan participant, and among the plan participants, which do not occur in defined contribution plans.[137] It does not follow that simply because defined benefit plans can be used by small firms to provide larger benefit accruals for older employees, that defined contribution plans should be able to do so as well.

b. Eliminate Age-Weighted Profit-Sharing Plans in Firms that Also Sponsor a Defined Benefit Plan

The argument that a firm should be able to sponsor an age-weighted profit-sharing plan because the results can be replicated in a defined benefit plan do not apply when a firm also sponsors a true defined benefit plan providing the maximum benefit permitted under § 415 of the Internal Revenue Code.[138] In such situations, the firm could not provide additional age-weighted benefits through the adoption of a second defined benefit plan. Under the current regulatory structure, however, it can provide additional age-weighted benefits through an age-weighted profit-sharing plan. The use of cross-testing as a means for testing defined contribution plans on an age-weighted basis should at the very least unavailable in firms where older highly compensated employees are already receiving age-weighted benefits in a traditional defined benefit plan.[139]

c. Restore the Applicability of I.R.C. § 401(a)(26) to Defined Contribution Plans

In 1986, Congress added § 401(a)(26) to the Internal Revenue Code, which requires that plans cover at least 50 employees, or if the plan covers less than 50 employees, at least 40% of the employees. The statute provided that regulations could require each separate benefit structure within a single plan to be considered a separate plan.[140]

Section 401(a)(26) was intended to prevent firms from setting up several plans that in the aggregate formally comply with the nondiscrimina-

136. *See* Orszag & Stein, *supra* note 8, at 643-44.

137. Defined benefit plans shift the risk of adverse investment performance from the participant to the firm; the risk of long mortality to all plan participants; and in some plans the risk of steep compensation increases. *See* Orszag & Stein, *supra* note 8, at 650-56.

138. I.R.C. § 415 limits the amount of annual allocation to a defined contribution plan and the size of the ultimate retirement benefit from defined contribution plans. Currently, the largest annual allocation that may be made to a participant in a defined contribution plan is $40,000; the largest annual annuity benefit that may be paid to a participant from a defined benefit plan is $160,000. For a description of I.R.C. § 415, see Norman P. Stein, *Simplification and I.R.C. § 415*, 2 FLA. TAX REV. 69 (1994).

139. *See* Orszag & Stein, *supra* note 8, at 657-58.

140. I.R.C. § 401(a)(26)(I) (2002).

tion rules but nonetheless achieve a high degree of discrimination in favor of highly compensated employees.[141] The Internal Revenue Service ultimately concluded that the concern at which § 401(a)(26) was aimed required the use of a defined benefit plan. It therefore adopted a regulatory position of exempting most defined contribution plans from § 401(a)(26). Congress ultimately amended the statute to exclude defined contribution plans from the reach of § 401(a)(26), ratifying the IRS's view. The IRS also decided against exercising its regulatory authority to treat separate benefit structures as separate plans, reflecting its belief that the § 401(a)(4) regulations negated the need for this regulatory approach.[142]

The most serious problems with age-weighted profit-sharing plans occur when a firm sorts employees into different defined contribution plans or different benefits structures within a single defined contribution plan. This type of sorting is essentially the strategy that is used to create "new comparability" plans. Indeed, the new comparability approach is difficult to effect using a defined benefit plan because of § 401(a)(26). Thus, Congress should restore § 401(a)(26)'s applicability to defined contribution plans that use cross-testing and the IRS should exercise its regulatory authority to treat separate benefit structures as separate plans.

d. Limit Defined Benefit Plans in Small Firms

I have argued here and elsewhere that many small defined benefit plans do not facilitate the types of risk-shifting that the defined benefit structure is designed to accommodate.[143] In particular, the defined benefit plan structure shifts the risk of poor investment performance to the firm and the risk of long mortality to the participants as a group.[144] In many small defined benefit plans, where only the firm's owners will accrue significant benefits, both types of risk-shifting are highly attenuated.[145] First, the risk of poor investment performance is shifted from the owner-employees to the firm, which generally means the risk is not shifted at all. Second, the risk of long mortality is unlikely to be shifted if, as is generally the case with small defined benefit plans, most employees will receive their benefits in a lump sum rather than as a life annuity. The use of the defined benefit plan structure, which generally imposes high administrative costs, wastes resources if the plan does not result in either type of risk-shifting.

There are two other difficulties with many small firm defined benefit plans. First, the implicit bargain struck between firm and employee in a defined benefit plan in a large firm is that the employee will be rewarded

141. *See* Final Regulations, Minimum Participation pmbl., 56 Fed. Reg. 63410 (Dec. 4, 1991).

142. *Id.* at 63415.

143. *See* Orszag & Stein, *supra* note 8, at 643-44.

144. *Id.*

145. *Id.*; *see also* Norman P. Stein, *Some Policy Implications of the IRS' Small Defined Benefit Plan Audit Program*, 55 TAX NOTES 1407 (1992).

for a long job tenure by accruing valuable pension benefits toward the conclusion of the employee's career. In some small firms, where the owner's retirement might mean the end of the firm (or at least the firm's sponsorship of a defined benefit plan), younger employees will not have the opportunity to achieve a sufficiently long tenure to participate in the valuable part of the plan's accrual curve. Second, firms with older owners have incentive to avoid hiring older workers, since the costs of their participation in the defined benefit plan would be high.

For these reasons, I have advocated elsewhere that small firms not be permitted to adopt defined benefit plans (or age-weighted defined contribution plans) unless there is an assurance that the plan will be permanent, meaning that it will likely continue beyond the retirement of the firm's owners.[146] Such plans do not provide the risk-shifting that true defined benefit plans are designed to facilitate, and exist largely to allow the firm to design the plan so that only a firm's older owners receive meaningful benefits. These plans are inconsistent with the justification for the tax subsidy, since they operate to weight benefits toward highly compensated employees and away from the lower and middle-income employees, who are the primary target of the tax expenditures.

The next group of suggestions (e-j) identifies ways to increase benefits through changes to the minimum coverage and eligibility rules of I.R.C. § 410, which are designed to ensure that firms cover a proportionate sampling of non-highly compensated employees.

Section 410 of the Internal Revenue Code, as it is now structured, compares the percentage of highly compensated employees covered by a plan to the percentage of non-highly compensated employees. If the percentage of covered non-highly compensated employees is at least 70% of the percentage of highly compensated employees, the plan satisfies § 410(b).[147] If the plan does not satisfy this test, it can still satisfy § 410 through compliance with an alternative test, the average benefits test.[148] Under this test, the ratio percentage between highly and non-highly compensated employees can drop as low as 20%, depending on the concentration of non-highly compensated individuals in the firm's workforce and other factors, so long as an average-benefit condition is also satisfied.[149] The average-benefit condition requires that the average benefit of non-highly compensated employees (in all qualified plans of the employer) at least equal 70% of the average benefit of the firm's highly compensated employees.[150]

146. *See* Orszag & Stein, *supra* note 8, at 653; Stein, *supra* note 145.
147. I.R.C. § 410(b)(1)(A), (B) (2002).
148. I.R.C. § 410(b)(1)(C)-(b)(2) (2002).
149. Treas. Reg. § 1.410(b)-4 (as amended in 1992).
150. I.R.C. § 410(b)(2)(A)(ii) (2002).

e. Revise the Definition of Highly Compensated Employee

The current test for highly compensated employees is that the employee is either a 5% owner of the firm or earns at least $80,000 annually, a figure that is adjusted to reflect increases in the cost of living and, in 2002, stands at $90,000.[151] A firm may elect, however, to limit highly compensated employees (on the basis of their compensation) to the top 20% of employees based on compensation.[152]

There are several conceptual problems with this definition. The first is that the $90,000 threshold means different things in different regions of the country, and within different parts of different regions. In a city such as San Francisco, $90,000 may accurately define a highly compensated individual, but in Tuscaloosa, Alabama, where I teach, a much smaller percentage of the population earns at least $90,000. A second problem is that highly compensated means different things at different age levels: a young business school graduate earning $65,000 is, to my mind, highly compensated even though his compensation falls below the $90,000 threshold. A third problem is the definition's division of the workforce into two neat groups, which contemplates a very blunt comparative test of coverage rates among a firm's employees. (It would, for example, be possible for many firms to exclude their least well-compensated non-highly compensated employees and still pass the coverage tests.) These problems each suggest the need for revisiting the issue of the overall usefulness of a single definition of highly compensated employee and the resulting limitations on the coverage comparison.

But for the purposes of this paper, I focus on a simpler issue: the ability of a plan sponsor to choose to limit highly compensated employees to those among the top 20% in rank compensation. It is difficult to understand the conceptual basis for providing employers a choice of definition of highly compensated employee unless it is to permit the employer to manipulate the required coverage percentage for employees earning less than $90,000. The statutory path to preventing such manipulation is to remove this elective feature and select one test or the other. Or, at the cost of complexity, require the firm to treat employees who meet the highly compensated dollar threshold but are not in the top 20% group as highly compensated if they participate in the plan, non-highly compensated it they do not.

f. Revise the Exclusion for Unionized Workers

Section 410 excludes from the minimum coverage test "employees who are included in a unit of employees covered by a [collective bargaining] agreement . . . if there is evidence that retirement benefits were the subject of good faith bargaining between" the labor organization and the

151. I.R.C. § 414(q) (2002).
152. I.R.C. § 414(q)(1)(B)(ii) and (q)(3).

employer."[153] This provision can be justified as consistent with the law of labor/management relations, in which we assume that the employees' bargaining representative will negotiate the optimal division between cash wages and fringe benefits. Excluding such employees from the coverage tests, however, is inconsistent with the orthodox explanation of the qualified plan tax expenditure, which generally conditions favorable tax treatment on proportionate coverage of non-highly compensated employees.[154] Moreover, there are few provisions in Federal employment law, including most aspects of ERISA, that can be waived by employee bargaining representatives through collective bargaining. The statute should be amended to delete the exclusion.[155] Perhaps benefits nondiscrimination testing, however, could be waived if a collective bargaining agreement satisfies some safe-harbor threshold for deferred compensation.

g. Condition Exclusion of Employees on Immediate Vesting

Under current law, a plan is required to cover only a percentage of non-highly compensated employees. The percentage varies between 20% and 70% of the number of highly compensated employees covered by the plan.[156] Some, including Professors Daniel Halperin and Alicia Munnell, have argued that a plan should be required to cover all employees in a line of business of an employer.[157] Although I would support such a rule, I suggest a compromise approach here, which reflects my concern that in some firms many rank-and-file employees accrue but ultimately forfeit benefits because they separate from service in less than five years. Covering employees who forfeit their benefits is no better than failing to cover them in the first instance. Thus, I would support a rule limiting the ability to exclude rank-and-file employees from plan coverage unless the plan provided for immediate vesting upon plan entry. While such a rule would face considerable political opposition, it would face at least somewhat less opposition than the still more attractive rule advocated by Professors Halperin and Munnell.

h. Modify the Average Benefits Test

The average benefits test permits a plan to satisfy the minimum coverage requirement even though the percentage of non-highly compensated

153. I.R.C. § 410(b)(3)(A) (2002).

154. Moreover, unions in relatively highly paid industries generally negotiate pension benefits, while unions in lower-paid industries are less likely to be able to negotiate such benefits. Thus, the exclusion may well have the effect of denying pension coverage to those employees least likely to save on their own for retirement.

155. There are many occasions where the exclusion will make it more difficult for a plan to satisfy the coverage tests of § 401(b). If, for example, a plan covers a firm's compensated, non-union employees, including many highly compensated union employees, but excludes non-union, non-highly compensated employees, it may not satisfy the coverage tests because the employer must exclude from consideration the union employees.

156. *See supra* text accompanying notes 147-50.

157. Daniel I. Halperin & Alicia H. Munnell, *Assuring Retirement Income For All Workers*, (March 2000), *available at* http://www2.bc.edu/~munnell/wp_2000-05.pdf.

employees can fall far below the 70% ratio percentage test.[158] A plan that uses this test, however, has to satisfy an additional test: the average benefits of the non-highly compensated employees has to be at least 70% of the average benefits of the highly compensated employees.[159] The methodology for making this comparison is to determine the benefit of each member of each group as a percentage of his or her compensation and then determine the average benefit of all members of the highly compensated group and of all members of the non-highly compensated group.[160] (An individual who does not participate in a plan, or does not accrue a benefit in a plan during a particular year, will have a benefit percentage of zero and must be included in the average.)

This methodology lends itself to gaming, since the employer can increase the average benefit for the non-highly compensated group at very low cost by providing high levels of benefits to the lowest paid employees or the employees least likely to vest in their benefits. (In some situations, the lowest paid employees will also be the same employees least likely to vest in their benefits.) To prevent this, I would add an additional layer to the average benefits test: a second test comparing the aggregate compensation and aggregate benefits of the highly and non-highly compensated employees on a group rather than average-of-individuals bases. Perhaps the ratio for this latter comparison would not need to be as high as 70% for the test to guard against the possible manipulation that the current test sometimes facilitates.

i. Require Immediate Plan Entry for Employees Excluded from Defined Contribution Plans on Account of Age or Service

ERISA permits a plan to exclude employees from participation until they attain age 21 and complete a year of service.[161] These seem to me to represent reasonable policy choices. But the statute allows a further delay of entry into plan participation, since the statute only requires that the employee commence participation no later than the earlier of the first day of the plan year, or the day that is six months after the employee satisfies the plan's age and service conditions.[162] A plan can satisfy this rule with two entry dates, one on the first day of the plan year and the second six months later. In effect, this means that some employees have to wait as many as six months after satisfying the plan's eligibility conditions before participating in the plan.

This delayed entry-date provision is a rule of administrative convenience for the employer, a rule that made sense in 1974 when Congress enacted ERISA. In today's world, in which technology has simplified recordkeeping and in which defined contribution plans typically permit par-

158. *See supra* note 149.
159. I.R.C. § 410(b)(2)(A)(ii) (2002).
160. I.R.C. § 410(b)(2)(B) (2002).
161. I.R.C. § 410(a)(1)(A) (2002).
162. I.R.C. § 410(a)(4) (2002).

ticipants to invest in mutual funds with frequent if not daily valuation, plans can with little added expense comply with a requirement of at least monthly entry dates.

j. Part-Time and Seasonal Employees

As noted, plan sponsors may design their plans to condition participation on an employee completing one year of service.[163] A year of service for this purpose is defined as the completion of 1,000 hours of service during a 12-month period.[164] This requirement allows firms to exclude from plan participation part-time and seasonal employees who do not work at least 1,000 hours annually. Moreover, a plan does not generally have to provide benefits to plan participants in any year that they work fewer than 1,000 hours,[165] and in a defined contribution plan if they are not employed on the last day of the year.[166] Thus, even if a part-time or seasonal employee satisfies the eligibility requirement in one year, the employee may not accrue a benefit under the plan. Such employees, it should be said, may also have a spotty employment history for purposes of Social Security and providing retirement benefits for them is consistent with the orthodox understanding of the qualified-plan tax subsidy.

Congress addressed the seasonal-employee issue in tentative, vague, and essentially nonsubstantive fashion in ERISA in 1974 by delegating authority to promulgate regulations defining year of service for any seasonal industry where the customary period of employment is less than 1,000 hours.[167] Almost three decades later there are no regulations in this area, nor have there been any proposed regulations. Moreover, the delegation of authority to draft such regulations would apply only to industries where the customary period of employment is less than 1,000 hours.[168] This would not address the issue of part-time, non-seasonal employees, nor would it necessarily address seasonal workers in industries where the customary period of employment exceeds 1,000 hours (for example, a retail store where most employees work more than 1,000 hours, may hire many extra employees every year during the holiday season).

Provision should be made for part-time and seasonal workers to participate in plans. Such a rule might reasonably require more than one year of part-time service before participation and might also permit employers to exclude such employees from the § 410(b) coverage requirements by covering them in a safe-harbor individual account plan to which the employer would contribute a designated percentage of their compensation.

163. I.R.C. § 401(a)(1)(A)(ii) (2002).
164. I.R.C. § 410(a)(3) (2002).
165. I.R.C. § 411(b)(4)(C) (2002).
166. Rev. Rul. 76-250, 1976-2 C.B. 124; 29 C.F.R. § 2530.200b-1(b) (2003).
167. I.R.C. § 410(a)(3)(B) (2002).
168. *Id.*

The next group of suggestions (k-o) involve § 401(k) plans, which, since their inception in the early 1980s, have become the most popular form of qualified deferred compensation plan, and plans—401(k) or otherwise—that are top-heavy, i.e., subject to the requirements of Internal Revenue Code § 416.

Section 401(k) plans permit employees to elect between immediate compensation or deferral of compensation into the § 401(k) plan. The policy issue with § 401(k) plans is that participation is optional and some employees who would have been compelled to participate in a defined benefit or traditional defined contribution plan may decline participation in a § 401(k) plan. Empirical data shows that lower- and middle-income employees have relatively low rates of participation in § 401(k) plans.[169]

Section 401(k) has an interesting history and the § 401(k) plans, as we know them today, might be thought of as an unintended consequence of legislation designed to address a narrow issue. Prior to ERISA, it had been a practice in the banking industry for firms to offer a year-end bonus, which could be taken in cash or contributed to a profit-sharing plan on a before-tax basis.[170] The IRS had permitted this practice but before ERISA began questioning whether an employee who elected deferral should be considered in constructive receipt of the contribution. In 1978, Congress passed legislation designed to approve such plans if the contributions were not weighted heavily in favor of highly paid employees.[171]

A story, almost certainly true, is that a pension consultant named Ted Benna realized that § 401(k) seemed to authorize plans in which employees could elect to defer a portion of their regular compensation throughout the year.[172] In 1981, the Department of Treasury issued regulations endorsing this reading of the statute, setting the stage for the § 401(k) revolution.[173]

Section 401(k) plans solve a plan sponsor dilemma: how to provide qualified deferred compensation only to those employees who value such compensation at (at least) its cost to the plan sponsor. But § 401(k) also creates, in mirror-image fashion, a conflict with the justification for the

169. *See* Department of Labor, Pension and Health Benefits of American Workers Table C7 (1994), *available at* http://www.dol.gov/ebsa/programs/opr/bluebook/c_7.htm.

170. *See* David L. Raish, Cash or Deferred Arrangements, Tax Management Portfolio 358, at 4 (3d ed. 1997) (explaining Internal Revenue Service issuance of proposed salary reduction regulation and ERISA moratorium on issuance of such regulations).

171. *See* I.R.C. § 401(k)(3) (1979). At the time, the Internal Revenue Code did not include a general definition of "highly compensated employee," as it now does in I.R.C. § 414(q) (2002). The original § 401(k) provisions defined "highly compensated employee" as those employees in the upper third of compensation for the employer. *See* I.R.C. § 401(k)(3) (1979).

172. *See* Jay Thomas Scholz, *Pension Consultant Behind Today's Popular 401(k) Retirement Plan*, San Antonio Bus. J. (Mar. 9, 2001) (detailing history of § 401(k) plans), *available at* http://sanantonio.bcentral.com/sanantonio/stories/2001/03/12/focus8.html.

173. *Id.*

qualified-plan tax expenditure, since the employees least likely to elect to defer are the ones least likely to save on their own for retirement.

Today there are three types of § 401(k) plans, whose distinguishing characteristics include the methods they are permitted to use as a surrogate for § 401(a)(4) nondiscrimination testing. Nondiscrimination compliance in a basic § 401(k) plan is determined by comparing the deferral rates of non-highly compensated and highly compensated employees.[174] The average deferral rate for the non-highly compensated employees can, in some cases, be as little as 50% of those of the highly compensated employees, but more typically will be somewhat higher than that.[175]

Nondiscrimination testing in the two other types of 401(k) plans—the safe-harbor 401(k) plan[176] and the SIMPLE 401(k) plan[177]—are based solely on plan design. In safe-harbor 401(k) plans, the employer must make matching contributions of 100% for elective deferrals up to 3% of compensation, and 50% of additional elective contributions up to an additional 2% of compensation.[178] Alternatively, the employer can simply make nonelective contributions equal to 3% of compensation.[179] In a SIMPLE 401(k) plan, which is limited to small employers,[180] the employer need only make a matching contribution equal to the first 3% of compensation or a nonelective contribution equal to 2% of compensation.[181]

k. Replace the Safe-Harbor and SIMPLE 401(k) Safe Harbors With a Reverse Match.

The safe-harbor and SIMPLE 401(k) plans, which mandate a match but do not reward the employer for positive employee responses to it, create for the employer an incentive to discourage employee contributions.[182] This contrasts with basic 401(k) plans, where the ability of highly com-

174. I.R.C. § 401(k)(3) (2002).

175. The discrimination tests permit the average deferral percentage of highly compensated employees to exceed that of non-highly compensated employees by 2%, so long as it is not more than twice the non-highly compensated employee deferral percentage. I.R.C. § 401(k)(3)(A)(ii)(II) (2002). Thus, if the average deferral percentage for highly compensated employees is 2%, the average deferral percentage for highly compensated employees can be 4%.

176. I.R.C. § 401(k)(12) (2002).

177. I.R.C. § 401(k)(11) (2002).

178. I.R.C. § 401(k)(12)(B) (2002).

179. I.R.C. § 401(k)(12)(C) (2002).

180. I.R.C. § 401(k)(11) (2002). Only an eligible employer can adopt a SIMPLE plan. *Id.* The definition of eligible employer is cross-referenced to I.R.C. § 408(p). *See* I.R.C. § 401(k)(11)(D)(i) (2002). I.R.C. § 408(p)(2)(C) defines eligible employer as "an employer which had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year."

181. I.R.C. § 401(k)(11)(B) (2002).

182. The statute does, however, require the employer to provide employees notice of their right to participate and receive a matching contribution. *See* I.R.C. § 401(k)(11)(B)(iii) (2002) (defining SIMPLE plan); I.R.C. § 401(k)(12)(D) (2002) (defining safe-harbor 401(k) plan).

pensated employees to make elective deferrals is tied to the deferral rate of the non-highly compensated employees.

The purpose of the special safe-harbor matching nondiscrimination tests is to encourage formation of § 401(k) plans by eliminating the employer's need to engage in annual calculation and testing of average rates of deferral for highly and non-highly compensated employees. I have suggested elsewhere, with Peter Orszag, another safe-harbor approach based on a reverse match.[183] Under this approach, the employer would make an initial contribution for all participants and highly compensated employees' elective deferrals would be limited to a statutory multiple of the initial contribution rate the employer made. For example, if Congress set the multiple chosen at 2 and the employer made 3% contributions, highly compensated employees would be permitted to defer an additional 6% of their compensation. This approach avoids complicated annual testing and has the important advantage over the current safe-harbor approaches of ensuring that all participants are allocated an initial contribution. It also ties the amount that highly compensated employees can defer to the amount being deferred for rank-and-file employees.

l. Provide that Non-Highly Compensated Employees Immediately Vest in Employer Matching and Nonelective Contributions to 401(k) Plans.

Under current law, employer-matching contributions do not become nonforfeitable until an employee has three years of service under the plan.[184] From the vantage of public policy, the match is designed to induce savings behavior on the part of reluctant savers. From the employer's perspective, the purpose of the match in the case of a 401(k) plan is to encourage the participation of non-highly compensated employees in the plan, thereby increasing the amounts that the firm's highly compensated employees can defer.

Congress should consider making matching employer contributions immediately nonforfeitable. (I note that the employer may have an incentive to immediately vest employees in matching contributions if delayed vesting is not adequate to cause the non-highly compensated employees to defer to levels desired by the employer. I worry, though, that some employees who respond to an employer match may not fully understand that the match can be forfeited if they do not accumulate three years of service, and thus already assume that they will vest in the employer matching contribution.) Given that matching contributions must vest over three years now, it is unlikely that many employers would incur substantial additional cost by making matching contributions immediately nonforfeitable, and if it does increase costs the employer could in some cases compensate for them by slightly lowering the matching percentage.

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183. *See* Orszag & Stein, *supra* note 8, at 669-74.

184. In contrast, both employer and employee contributions in a SIMPLE 401(k) plan vest at the time of contribution. I.R.C. §§ 401(k)(11)(A)(i)(III), 408(p)(3) (2002).

If an employer's costs are increased appreciably, it means that many employees are forfeiting the matching contribution because they do not accumulate three years of service; in such cases, one might question whether the plan is adequately serving the retirement needs of non-highly compensated employees.

m. Repeal I.R.C. § 416(g)(3)(H), which Exempts Safe-Harbor and SIMPLE 401(k) Plans From the Top-Heavy Rules

Section 416 of the Internal Revenue Code brands certain plans as top-heavy. A plan is top-heavy if "key employees" account for more than 60% of the plan's benefits.[185] A top-heavy plan must satisfy two additional requirements to retain its tax qualification, one of which is to provide a minimum benefit.[186] For defined contribution plans the minimum benefit is an employer contribution of 3% of compensation for each non-key employee.[187] Neither SIMPLE nor safe-harbor 401(k) plans are subject to the top-heavy rules.[188] As a result, a SIMPLE or safe-harbor 401(k) plan can retain qualified status even if it provides no benefits to non-highly compensated employees. Such plans do not contribute adequately to national retirement income policy to justify favorable tax treatment. I would subject them to at least some variation of the top-heavy rules.[189]

n. Do Not Permit Matching Contributions in § 401(k) Plans to Count Toward Minimum Benefits Under I.R.C. § 416.

Prior to passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the Internal Revenue Service took the position that employer matching contributions to 401(k) plans could not be counted toward the minimum benefit requirement applicable to top-heavy plans.[190] Congress, as part of EGTRRA, legislatively reversed this position.[191] There are two reasons to question Congressional judgment here. The first is that matching contributions are intended to induce savings behavior on the part of the employee. If the employer would be required to make a top-heavy contribution of 3% regardless of whether the employee contributes, the incentive for the employee to contribute is reduced. The second reason to question Congressional judgment is that the 401(k) nondiscrimination rules and § 416 have different purposes: the § 401(k) nondiscrimination rules are designed to ensure that the year's deferrals do not unduly discriminate in favor of highly compensated employees; the top-heavy rules, on the other hand, determine whether the

185. *See* I.R.C. § 416(g)(1)(A) (2002).
186. I.R.C. § 416(c) (2002).
187. I.R.C. § 416(c)(2) (2002).
188. I.R.C. § 416(g)(4)(H) (2002).
189. As noted earlier, I would prefer to see safe-harbor plans based on a reverse-match model.
190. Treas. Reg. § 1.416-1, M-19 (2003).
191. I.R.C. § 416(c)(2) (2002).

aggregate account balances to date are out of balance with the purpose of the tax expenditures—to create retirement income security for those least able to save on their own. Allowing a 401(k) matching contribution or nonelective contribution to satisfy the minimum benefit requirement of § 416 dilutes the purpose of that requirement, to move the plan toward aggregate account balances more consistent with the purpose of the tax expenditures for qualified plans. Indeed, if the 401(k) plan were, for example, making nonelective and matching contributions to meet the annual testing requirements and the plan remained top-heavy, allowing the employer 401(k) contributions to work double duty as a minimum benefit will not move the plan over time to the better overall balance between highly compensated and non-highly compensated employees that § 416 is purportedly effecting.

o. Revise the Definition of "Key Employee" for Top-Heavy Plans

The definition of "key employee" for purposes of § 416 was until this year focused more on employees with significant ownership or control interests in the employer than was the current definition of highly compensated employee, which, except for 5% owners, groups employees into one of two compensation groups—highly or non-highly compensated. Thus, a plan could be top-heavy even if none of the employees were highly compensated.

Until 2002, the definition of "key employee" included four groups of employees:

(1) one of the ten employees whose annual compensation exceeds the § 415 limit for defined contribution plans (in 2001, $35,000) and owning the largest interests in the employer;
(2) officers of the employer with annual compensation of half the § 415 limitation for defined benefit plans (in 2001 the compensation that would make an officer a key employee was $70,000);
(3) a five-percent owner of the employer; or
(4) a one-percent owner of the employer whose compensation exceeded $150,000.[192]

Key employee status was determined with reference to each of the five years previous to the year in which top-heavy status was determined.[193]

Congress amended the definition of "key employee" as part of EGTRRA, effective for plan years beginning in 2002. The Act eliminated the first owner definition listed above and increased to $130,000 the compensation applicable to the second owner definition.[194] In addition, key employee status is now determined by looking back only a single year rather than four years.[195] The Act thus reverses a decade and a half of prior statutory language in which the concept of key employee (at least for

192. I.R.C. § 416(i)(1)(A)(i)-(iv) (2002) (pre-EGTRRA).
193. I.R.C. § 416(i)(1)(A) (2002).
194. I.R.C. § 416(i)(1) (2002).
195. *Id.*

small, owner-dominated firms) was broader than that of highly compensated employee. The Act will effectively exempt from top-heavy status any plan without a highly compensated employee. It will reduce, perhaps substantially, the number of top-heavy plans.

The purported reason that Congress reigned in the definitional scope of top-heavy status was its determination that the top-heavy rules were a significant disincentive for plan adoption in the small business sector.[196] In doing so, Congress ignored research suggesting that the most common reasons small plans do not sponsor retirement plans are that they lack substantial profitability to support a plan and that many employees do not value deferred compensation at its cost to the employer.[197] In addition, the General Accounting Office prepared a study suggesting that the top-heavy rules did not add much complexity to maintenance of a plan, nor did they substantially discourage plan sponsorship.[198] The EGTRRA changes were unnecessary and will have the effect of reducing benefits for many employees, particularly in firms that have no highly compensated employees.

EGTRRA made other changes that will likely effect a reduction in pension and profit-sharing benefits for lower- and middle-income employees. The next group of suggestions (p-s) suggest repeal of four such EGTRRA changes: (1) the increase to the § 401(a)(17) cap on compensation, (2) the increase in the amount of permitted elective deferrals, (3) the increase in the amount that can be contributed to an individual retirement account, and (4) the creation of catch-up contributions for employees over age 50.

p. Restore the Pre-EGTRRA Compensation Limits

Section 401(a)(17) sets a limit on the amount of compensation that can be taken into account by a qualified plan. The effect of the compensation cap in cases where a firm is attempting to provide a target level of benefit for a highly compensated employee is to increase benefits for less well compensated individuals. To illustrate, assume that a firm wants to contribute $30,000 to a defined contribution plan for a favored employee who has $300,000 in compensation. This would require a contribution of 10% of pay, which would require contributions of 10% of pay for other employees.[199] If compensation is capped at $150,000, however, the firm

196. *See* H.R. Rep. No. 107-51, at 59 ("While the top-heavy rules were intended to provide additional minimum benefits to rank-and-file employees, the Committee is concerned that in some cases the top-heavy rules may act as a deterrent to the establishment of a plan by a small employer."), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_reports&docid=f:hr051p1.107.pdf (last visited Feb. 5, 2003).

197. *See* Employee Benefit Research Institute, *supra* note 23.

198. General Accounting Office, Private Pensions: "Top Heavy" Rules for Owner Dominated Plans, GAO/HEHS-00-141 (August 2000).

199. In fact, the contribution could be somewhat less than 10% if the plan, for example, was integrated with Social Security or was age-weighted. But the contribution percentage for the non-highly compensated employees would relate to the contribution percentage for the highly compensated employees, with a higher percentage for the latter group resulting

would have to contribute 20% of compensation in order to provide the favored employee with a $30,000 allocation, increasing the contribution level for all employees.

Prior to EGTRRA, the compensation cap was $150,000, but adjustments to reflect increases to the cost of living pushed it up to $170,000.[200] Through EGTRRA, Congress pushed the cap to $200,000,[201] thereby enabling employers to decrease contribution levels for all employees earning less than $200,000. This provision should be repealed.

q. Reduce the IRA Contribution Level

Prior to EGTRRA, an individual could contribute up to $2,000 annually to an individual retirement account; the individual's spouse could also contribute $2,000, even if the spouse had no income of his own.[202] EGTRRA increases the limit to $5,000 for individuals under 50[203] and to $6,000 for individuals over 50.[204] The legislative history of EGTRRA indicates that Congress believed that this limit increase was overdue, given that the limit had not been increased since 1981.[205]

Increasing the limits creates a serious problem for pension coverage of rank-and-file employees of small businesses. Prior to the increase, an owner of such a business had to set up a qualified plan to defer more than $2,000 ($4,000 if married) of her compensation. The plan would necessarily provide benefits for rank-and-file employees as well. After the EGTRRA changes, the business owner could defer up to $6,000 ($12,000 if married) through contributions to an individual retirement account, without providing any benefits for employees.[206] Congress apparently overlooked this unfortunate result. This EGTRRA change, then, will probably result in fewer, rather than more, plans. Moreover, the contribution increase will probably not help the many middle- and lower-income individuals for whom a contribution of $2,000 would already be difficult.

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in a higher percentage for the former. In the textual discussion, for purposes of simplicity, I assume that the nondiscrimination rules require strict proportionality between the two groups.

200. *See* I.R.S. Notice 2001-84, 2001-53 I.R.B. 642. The Internal Revenue Service also issued a revenue ruling in early 2003 that permits employers to amend their plans to give former employees the benefit of the higher limits, even though they had left employment prior to the effective date of the provision. Rev. Rul. 2003-11, 2003-3 I.R.B. 1.

201. I.R.C. § 401(a)(17) (2002).

202. I.R.C. § 219(b)(1) (2001) (pre-EGTRRA).

203. I.R.C. § 219(b)(5) (2002). The increase in the limits is phased in $1,000 increments every two years and thus does not become fully effective until 2008.

204. I.R.C. § 219(b)(5)(B) (2002). The catch-up contribution is currently $500 and will be increased to $1,000 in 2006.

205. *See* H.R. REP. NO. 107-51, at 51, *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_reports&docid=f:hr051p1.107.pdf (last visited Feb. 5, 2003).

206. In addition, an individual could use a Roth IRA, which, as explained below, *infra* note 236 and accompanying text, effectively increases the contribution limits.

r. Reduce the Limit on Elective Contributions

If a firm sponsors only a 401(k) plan, employees will be limited to their elective deferrals and any employer matching contribution. Prior to EGTRRA, the limit on elective deferrals was $10,500.[207] EGTRRA increased the limit to $11,000 for 2002, and by $1,000 increments for the years 2003 through 2006, when it will reach $15,000.[208] Increasing the limits will encourage some firms to substitute 401(k) plans for traditional defined contribution plans that benefit a higher percentage of employees. Other firms that currently sponsor both a 401(k) plan and a traditional defined contribution plan will be encouraged to drop the traditional plan, if, with the expanded limits, key employees can defer desired amounts under the 401(k) plan alone.

s. Eliminate or Limit the Use of Catch-Up Contributions

Through EGTRRA, Congress provided that employees over age 50 could make catch-up contributions of up to $5,000 to § 401(k) plans, in addition to their elective deferrals.[209] The catch-up contributions are not subject to the § 401(k) or other nondiscrimination rules, or to the § 415 limitations.

Congress's purported purpose in enacting the catch-up provision rules was to help women who enter the workforce relatively late in life and as a result are undersaved for retirement.[210] The provision, however, is not limited to women or to people who are undersaved for retirement, and is likely to be used primarily if not exclusively by upper-income individuals who, generally speaking, will have substantial assets for retirement. The provision, which will provide virtually no benefits to non-highly compensated employees, is an extraordinary misdirection of the tax subsidy for qualified plans.

Moreover, in certain situations the catch-up provisions will result in reduction of benefits for lower- and middle-income employees. For example, assume a firm sponsors a 401(k) plan and the firm's owner has a target deferral rate of $10,000 for himself, which is 10% of his compensation. To defer at this rate, the owner has had to make non-elective and

207. I.R.S. Notice 2001-84, *supra* note 200.

208. I.R.C. § 402(g)(1) (2002).

209. I.R.C. § 414(v) (2002).

210. The catch-up provisions were included in Title III of EGTRRA, which is titled "Fairness to Women." The committee reports include a single specific example of why the provision was necessary: family caregiver leaves employment while young and returns to the workforce later in life. *See* H.R. Rep. No. 107-51, at 69-70, *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_reports&docid=f:hr051p1.107.pdf (last visited Feb. 5, 2003). *See also* Press Release, Comm. on Educ. & the Workforce, Portman-Cardin Bill Sails Through House Workforce Committee (April 26, 2001), *available at* http://edworkforce.house.gov/press/press107/hr10pc42601.htm (quoting Education and the Workforce Chairman John Boehner as stating: "It allows workers over age 50 to make additional 'catch-up' contributions to their pension plans and lowers the vesting requirement for employer matching contributions from five years to three years. These provisions, among many others in the bill, will provide women who have re-entered the workforce later in life with a more secure retirement.").

matching contributions for the non-highly compensated employees to bring their deferral rate to 8%.[211] If the employee is over 50, however, the employee can, in effect, defer $5,000 without regard for the nondiscrimination rules and only $5,000 of his contribution would depend on the level of non-highly compensated deferral. This level of deferral can be obtained with a 3% deferral rate for the other employees,[212] which the firm can probably accomplish with matching contributions and nonelective deferrals lower than would otherwise be needed.

Moreover, if the firm's owner is eligible for and not adverse to a Roth IRA,[213] he can set up a 401(k) plan without matches, he can make a $5,000 contribution to the Roth IRA and a $5,000 catch-up to the 401(k) plan.

The catch-up provisions should, in my view, be repealed or targeted to employees who are undersaved for retirement.

The last of the suggestions to increase benefit levels for lower- and middle-income employees is modification of the rules for integration of private plans with Social Security.

t. Modify the Rules for Social Security Integration

The next suggestion is substantially to modify the rules for integration of private pension plans. Despite the nondiscrimination rules and their nominal insistence that benefits for non-highly compensated employees be proportionate to those of highly compensated employees as a percentage of compensation, the Internal Revenue Code permits firms sponsoring defined contribution plans to provide higher contribution rates for compensation above the Social Security taxable wage base. The Internal Revenue Code also permits firms sponsoring defined benefit plans to provide larger benefit accrual rates for benefits above the wage base or to reduce benefits by a percentage of Social Security benefits.[214] The rationale for Social Security integration is that a firm makes contributions to the federal retirement system up to the Social Security taxable wage base and should be able to integrate at least some of the benefits purchased with those contributions with the benefits provided in the firm's own pension or profit-sharing plan.[215]

Integrating private deferred compensation plans with Social Security has been criticized as merely a legalized form of providing lower private pension benefits to lower-paid employees. Nancy Altman has argued that integration could be justified if the rationale for the nondiscrimination rules is to prevent plans from being maintained as tax shelters for the highly compensated (which she argues was the original justification for

211. *See* I.R.C. § 401(k)(3)(A)(ii) (2002) (describing operation of ADP test).
212. *Id.*
213. I.R.C. § 408A (2002). An individual can use the full Roth limits if her adjusted gross income does not exceeds $150,000. I.R.C. § 408A(c)(3)(A), (C) (2002).
214. *See generally* I.R.C. § 401(l) (2002).
215. *See generally* Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX. L. REV. 476 (1987).

the nondiscrimination rules), but cannot be justified under the worker protection justification for the rules that informs tax and retirement policy today.[216] Professor Altman's article proposed that the current model for Social Security integration be replaced with a different model: that pension benefits should only be reduced to the extent that with Social Security benefits they exceed an employee's pay at the end of her career.[217] Professor Patricia Dilley has more recently argued that Social Security integration devalues the policies underlying the Social Security system and the private pension system and should thus be eliminated.[218] Moving Social Security integration toward this goal should be a fundamental part of any true reform agenda for the private pension system.

Increasing the Efficiency of the Tax Subsidy

The current tax regime for qualified plans probably wastes a considerable amount of the tax subsidy. The use of what amounts to a tax bribe to business owners and managers to establish plans is costly and plans sometimes provide trivial or no retirement benefits to moderate- and lower-income individuals, the reluctant savers whose retirement security is presumably the primary concern of the qualified plan tax regime. The system could be made more efficient if either the tax expenditure could be reduced without substantially reducing benefits for reluctant savers, or if the tax expenditures could be refocused to create larger benefits for reluctant savers.

The first part of this section, which considered suggested statutory modifications designed to increase coverage and benefit levels for lower- and middle-income individuals by shoring up the nondiscrimination rules, can in an important sense be seen as making the system more efficient, but strengthening the nondiscrimination rules poses the risk (which I think is often overstated) of reducing plan sponsorship, with loss of benefits for reluctant savers.

In this part, I suggest several statutory changes that have a different efficiency focus: moving the system away from the carrot/stick paradigm toward more direct targeting of the tax subsidy to the creation of retirement savings for middle-and lower-income individuals, including the use of tax credits and exclusion from income of certain retirement benefits. In this part, I also advocate reduction of what I consider wasteful tax benefits for plans that do not provide rank-and-file employees with significant benefits, which could help pay the costs of the new tax measures I advocate.

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216. *Id.*

217. *See* Altman, *supra* note 215.

218. Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063 (1997).

u. Expand and Modify Tax Credits to Encourage Low-Income Employees to Save for Retirement

EGTRRA introduced a tax credit for lower-income workers who contribute to an Individual Retirement Account or an employer 401(k) plan.[219] The maximum credit is 50% of the amount contributed (up to $2,000), which applies to individuals with $15,000 or less in adjusted gross income.[220] The credit then drops to 20% for individuals with income over $15,000, but less than $16,250, and then drops to 10% for individuals with income up to $25,000.[221]

There are a number of reasons why the credit is not likely to contribute significantly to the retirement security of those it is designed to aid. First, the credit is nonrefundable.[222] The earned income tax credit and the child care credit, which reduces to zero the taxes paid by many families eligible for the credit, will mean that many taxpayers eligible for the credit will derive no benefit from it.[223] Second, the income thresholds are not indexed to inflation, a stark departure from almost every other retirement plan limit in the Internal Revenue Code. Third, the credit declines to 20% once a taxpayer's adjusted gross income exceeds $15,000, and declines to 10% when income exceeds $16,250.[224] It is questionable whether a credit of 10% or even 20% will be sufficient to motivate many low-income workers to save for retirement. Fourth, the credit will only be available for five years (unless affirmatively extended by Congress).[225] Fifth, Congress designed the credit in apparent ignorance of the work of behavioral economists, whose research suggests that workers avoid savings programs in which their paycheck declines, which would be the effect if people make voluntary deferrals to an employer plan.[226] And most people in the income range eligible for the credit will not have sufficient sums of money to make an end-of-the-year IRA deposit to qualify for the credit.[227] (It is probably unrealistic to believe that potential recipients of the credit will make small weekly IRA deposits and it is probably accurate to say that investment institutions will not eagerly court this market.)

The most likely effect of the credit will be to reduce slightly the taxes of low- and moderate-income people who are already saving in their em-

219. I.R.C. § 25B (2002).

220. I.R.C. § 25B(b) (2002).

221. *Id.*

222. I.R.C. § 25B(h) (2002).

223. *See* I.R.S. Announcement 2001-106, 2001-44 I.R.B. 1. *See generally* Craig G. White, *Does the Savers' Credit Offer An Incentive to Lower-Income Families?*, 96 TAX NOTES 1633 (2002).

224. I.R.C. § 25B(b) (2002).

225. I.R.C. § 25B(g) (2002).

226. RICHARD H. THALER, THE WINNER'S CURSE 76 (1991); Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving* (Nov. 2000), *available at* http://economics.uchicago.edu/download/savemore.pdf.

227. *See* White, *supra* note 223.

ployer's 401(k) plan. In my view, it is improbable that the credit, as currently structured, will create significant new stores of retirement savings.

The idea of such a credit, however, is worth implementing in a form more likely to have the intended result. Among changes that might be considered to make the credit more effective are the following:

1. Make the credit refundable.
2. Allow an employer match to a 401(k) plan count as the participant match for the credit.
3. Increase the credit percentage levels.
4. Consider extending the credit to higher income levels for employees over 50 (on the same theory that supports catch-up contributions for affluent employees).
5. Allow the employee to borrow the match from the federal fisc on an interest-free basis, with the repayment secured by the employee's plan benefits and due when amounts are withdrawn from the plan.

v. Use Tax Credits to Encourage Particular Plan Design Features

Rather than rely solely on a carrot/stick method of delivering the qualified plan tax expenditure, Congress might consider providing direct tax credits to firms whose plans satisfy certain specified design features such as immediate participation of all employees, immediate vesting, coverage of part-time employees, and non-integrated benefit and allocation formulas. Such tax credits should be limited, however, to plans that are not top-heavy in any credit year, so that the credit in fact benefits rank-and-file employees.

In thinking about the use of such tax credits, I note that virtually all employees attach some value to retirement savings, even if they prefer cash compensation. The tax credit should, in theory, be large enough to compensate the employer for the discount that reluctant savers attach to deferred compensation or to motivate the employer to educate its workforce about the value of retirement savings.

w. Attach Conditions to Expanded § 415 Limits

EGTRRA expanded the § 415 limits: the defined contribution limit was expanded from $35,000 to $40,000,[228] and the defined benefit limits from $140,000 to $160,000.[229] In addition, EGTRRA modified § 415 so that actuarial reductions for early commencement of retirement benefits apply only to the extent benefits begin before age 62.[230] A plan's ability to use these increased limits might be tied to the plan's inclusion of design provisions similar to those recommended for tax credits in subsection v. above.

228. Notice 2001-84, *supra* note 200.
229. *Id.*
230. *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 611(a), 115 Stat. 38, 96-97 (2001).

x. Exempt Retirement Benefits from Income for Low- and Moderate-Income Individuals

The tax benefits for accumulations in qualified retirement plans correlate with income level. To illustrate, consider $1,000 of compensation paid to a 35-year-old employee with a 39.6% marginal tax rate. If the employee paid tax on the $1,000 and invested it for 30 years, earning 6% annually compounded pre-tax interest, the employee will accumulate $1,757. If the compensation were invested in a qualified plan, the employee will accumulate $5,744. If the employee then received a distribution and paid tax at a 39.6% rate, he would be left with $3,469, or just under twice the amount outside the plan. Now consider a similar employee whose marginal tax rate is 15%. Outside the plan, the $1,000 would grow to $3,780; in the plan, the amount would grow to $5,744. If the employee then received a distribution and paid tax at a 15% rate, he would have $4,882, or a little less than 30% of the amount outside the plan.

One means of channeling more of the tax subsidy to lower-income employees would be to allow them a reduced rate of tax when they receive their benefits. In the above illustration, for example, a complete tax exemption of the benefit for the lower-income employee would result in his accumulating 52% more in the plan than out of the plan, still a substantially lower percentage than the higher paid of the two employees. I do not here suggest a formal scheme for effecting this approach, but a graduated system might be adopted in which all or a percentage of retirement plan benefits would be exempted from taxable income, depending on income level.

This raises a provocative issue: If the proposed tax benefit is to alleviate financial stress in old age, wouldn't it be more sensible to reduce marginal tax rates for lower- and middle-class elders generally, rather than exempt a particular type of income? I do not have a particularly appealing response to this question, and, as I indicated earlier in this article, I would prefer a more encompassing mandatory retirement savings program to the current tandem policy of Social Security and tax-subsidized private retirement plans. But one could make two observations here: first, the promise of tax-free returns might stimulate savings behavior on the part of at least some relatively low-income working people; and, second, the reality of such returns would direct more of the tax expenditure downward, perhaps paid for with reduced limits.

y. Reduce § 415 Limits for Certain Top-Heavy Plans

The amount of tax deferral available to highly compensated owners and employees of small firms was always large, but never larger than today. Part of this is due to EGTRRA, which increased the limits of §§ 415 and 401(a)(17). It is also due to a 1996 repeal of I.R.C. § 415(e),[231] a limitation that applied to employees who participated in both a defined benefit and a defined contribution plan maintained by a single plan sponsor. Section 415(e) was complex, but did constrain the total tax benefit that an employee could receive from participation in both types of qualified plans.[232] Moreover, a separate rule applied a still more constraining § 415(e) limit on employees in "super" top-heavy plans—plans in which 90% of the benefits were for key employees.[233] The rationale for the limitation on super top-heavy plans was that the tax benefit for key employees should be further constrained when rank-and-file employees are only accruing a small percentage of the plan's total benefits.

The repeal of the § 415(e) limit means that employees can now earn "full" § 415 benefits in both a defined benefit and a defined contribution plan. The repeal of the super top-heavy rules mean that this is true even for plans that provide little or no benefit for low- and moderate-income employees.

As I have noted, the current limits provide incredibly generous amounts of deferral for exceptionally affluent individuals. Let me offer two illustrations of this generosity: one from the perspective of career accumulations and one from the perspective of annual deductible plan contributions.

Career accumulation. Assume that a business owner sponsors both a defined contribution plan and a defined benefit plan, beginning at age 25. Also assume that the owner makes maximum contributions (set at the EGTRRA limits, with no inflation adjustments) to the defined contribution plan from the beginning. Further assume a 6% annual rate of return and no inflation. At age 65, the business owner could retire with well in excess of eight million dollars of assets in her qualified plan.[234]

Annual Deductible Amount. Assume that a business owner, who maintains a defined contribution plan, adopts a defined benefit plan at age 55. The owner could deduct contributions to these two plans of approximately $178,000 for each of the next ten years.[235]

This generosity is available even if the plan provides benefits only to the owner. This seems an extravagant waste of a tax expenditure whose

231. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1452(a), 1996 U.S.C.C.A.N. (110 Stat.) 1816.

232. *See generally* Norman P. Stein, *Simplification and I.R.C. § 415*, 2 FLA. TAX REV. 69 (1994).

233. I.R.C. § 416(h) (1996).

234. This assumes that the participant earned a defined benefit of $160,000 and that it had a present value at age 65 equal to 11 times the annuity amount, or $1,760,000. The defined contribution plan, under the assumptions given, would be $6,685,290.

235. Using the aggregate actuarial funding method, year-end contributions, a 6% interest and no pre-retirement mortality assumption, and a terminal defined benefit value of $1,760,000 at age 65, the annual contribution to fund the defined benefit would equal approximately $133,000; the individual could also be allocated $45,000 to a defined contribution plan. If the interest assumption were changed to 5%, the defined benefit contribution would increase to approximately $140,000, for a total annual contribution of $185,000 per year.

justification is the provision of benefits for reluctant savers of modest income. I would deny such generous limits to top-heavy plans, or at least to "super" top-heavy plans.

z. Repeal Roth 401(k) Plans

Roth 401(k) plans, modeled after Roth IRAs, permit participants to elect to make elective deferrals on an after-tax basis, but with the ultimate distributions exempt from tax. In effect, this allows the participant to shelter from tax not only the elective deferral but also the tax paid on the elective deferral, thereby increasing the maximum deferral amount. For a taxpayer with a marginal tax rate of 36%, the effective maximum elective deferral jumps from $15,000 to $23,437.50.[236] This increased limit, which one must charitably assume was not understood by Congress (nowhere in the various committee reports is the enhanced sheltering effect of the Roth tax scheme even noted), also undermines the ADP test, which is based on the nominal rather than effective deferral amounts. Further, the design and administrative impositions of a 401(k) plan setting up Roth accounts, and the participant decision about whether to designate a deferral a Roth deferral, adds complexity to qualified plans. Complexity and bad policy outcomes make a strong case for repeal.

VII. CONCLUSION

This article accepted a conventional view of the qualified-plan tax expenditure (i.e., that its primary purpose is to stimulate retirement savings for the lower- and middle-income working men and women who otherwise will undersave for retirement). The mechanism is tax carrot and regulatory stick—make retirement plans sufficiently tax-attractive to owners and managers of businesses that they have the incentive to cause their firms to first adopt a plan and then use regulatory mechanisms to ensure that the plan provide meaningful levels of benefits to target workers. Encouraging retirement savings in this way depends on a delicate calibration—providing the minimum amount of tax expenditure (for those who would save adequately for retirement) needed to stimulate plan formation, and the maximum amount of regulation (to ensure meaningful levels of benefits for those who would not save adequately for retirement) that a voluntary retirement system will tolerate. As Bruce Wolk pointed out more than 20 years ago, effecting this calibration is far from easy.

This article reflects the view that today's calibration is out of optimal balance and suggests a number of legislative changes that would provide more retirement savings for lower- and middle-income working people without increasing the cost of qualified plans or discouraging sponsorship of plans that create enough social benefit to justify their tax cost.

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236. The algebraic formula for calculating the effective increase is the regular limit divided by one less the individual's marginal tax rate (which I assumed to be 36%). The textual observation holds if the taxpayer's marginal tax rate remains at 36%.

In one sense, this article is merely a policy wish list, with commentary, and might be regarded as an analogue to the earlier wish list of various employer industry groups, which Congress hammered into statutory reality in EGTRRA. Some of the reform suggestions are technical modifications of the Internal Revenue Code provisions—modifications that would improve the operation of the nondiscrimination regime. Other suggestions are designed to improve the efficiency of the tax expenditure, sometimes with a modified carrot/stick approach (e.g., giving tax credits for plans that meet certain benefit distribution goals) or by using mechanisms that more directly deliver tax expenditures to the target population of workers. On the whole, my suggestions are guided by the idea that we need more *good* plans rather than simply *more* plans.

In a companion article, I will turn from consideration of the efficiency of the tax expenditure to other, albeit related, issues: pre-retirement dissipation of retirement savings, suboptimal exhaustion of retirement assets after retirement, orphan plans, and various problems with ERISA's substantive benefit protections and civil enforcement system, which sometimes leave elderly Americans without the retirement benefits they reasonably anticipated from their employers.