

ARTICLES

Targeted Pension Reform

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I. INTRODUCTION

The federal government's single largest tax subsidy today is for a retirement plan¹ system voluntarily sponsored by employers. In 2000, the amount of this tax subsidy was \$78.3 billion.² Given the magnitude of the tax dollars involved, one would hope this tax subsidy is designed to achieve the objective of national retirement policy,³ namely for elderly Americans to enjoy an "adequate income in retirement in accordance with the American standard of living."⁴ To the contrary, the pension tax law⁵ system that generates this enormous subsidy is driven not by policy, but rather by the ad hoc expediences of the federal budget balancing process. The troubling results have been instability and

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1. Throughout the article I use the terms "retirement plan" and "pension" or "pension plan" interchangeably. Unless the context indicates otherwise, both terms are used to refer to employment-based "qualified plans" that meet all of the requirements of Section 401(a) of the Internal Revenue Code of 1986, as amended, 26 U.S.C. § 401(a). As used in this article, the word "pension" refers to both defined benefit and defined contribution (also known as individual account) plans, including 401(k) plans. Qualified plans may or may not also be subject to the requirements of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of Titles 26 and 29 of the United States Code) [hereinafter "ERISA"]. Most significantly for purposes of this article, retirement plans sponsored by governmental employers are exempt from both ERISA, *see* 29 U.S.C. § 1002(32) (ERISA's definition of a governmental plan), § 1004(b)(1) (exempting government plans from coverage under ERISA), and from the minimum coverage requirements of Code Section 410(b) as revised by the Tax Reform Act of 1986, *see* I.R.C. § 410(c)(2)(A) (1994 & Supp. IV 1998).

2. *See infra* note 93.

3. By "national retirement policy" I am referring to an integrated view of Social Security and the tax policies that govern retirement plans and personal savings. *See* Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, U. PA. L. REV 851-907 (April 1987).

4. Older Americans Act of 1965, Pub. L. No. 89-73, 79 Stat. 218, § 101(a), *reprinted in* 1965 U.S.C.A.N. 233.

5. Unless the context indicates otherwise, references to "pension tax law" throughout the article refer to the requirements for qualified plans under Code Section 401(a).

chaos in the pension tax laws. The consequence has been a retirement plan system that fails to cover a substantial portion of the workforce, placing many workers at risk of having an inadequate income during retirement.

Part II of this article describes how the federal budget balancing process inevitably produces cycles in pension tax policy. In periods of budget deficits, pension tax law becomes more "complex" as Congress amends the laws to reduce the amount of the pension tax subsidy. These amendments, inscrutable except to relatively few pension tax law experts, are in effect hidden, and thus politically palatable, tax increases. Conversely, in times of budget surplus the political debate over tax cuts naturally extends to the pension tax laws, but often masquerades under the rubric of pension "simplification" or "fairness."

Today, the federal government has a large and well-publicized budget surplus. This surplus was estimated at \$232 billion for 2000.⁶ As a result, Congress is considering numerous legislative proposals aimed at pension tax law reform. Part III of the article describes the policy choices imbedded in these proposals. In Part III, I criticize much of the proposed pension reform legislation on three broad-based grounds. First, many of the proposals are unlikely to expand retirement plan coverage to workers who currently have none. Rather, these proposals are likely to enhance the benefits of higher income employees who already have retirement plan coverage, reversing the progress that had been made during the late 1980s and early 1990s toward making the pension tax law system more equitable. Second, the potential of many of these proposals for draining the fisc is likely to exaggerate the cyclical effects of the budget balancing process on pension tax law policy in the future. These cycles are detrimental because they undermine the predictability and stability of the employer-based retirement plan system for both employers and employees. Third, many of the proposals include provisions that would allocate explicitly a greater portion of the pension tax subsidy to persons age 50 and older. They essentially redistribute an even greater share of the pension tax subsidy to the soon-to-be retired wealthy. Such provisions are likely to exacerbate the intergenerational tensions that already exist in national retirement policy because of Social Security.

The proposals I criticize in Part III appear to be based on a tacit consensus among Congressional staff, outside experts, and lobbying groups concerning why pension coverage has failed to expand in scope. I refer to this consensus as the "traditional approach" to pension tax reform. During the late 1980s and early 1990s, Congress significantly reduced the tax incentives for employer-sponsored retirement plans. A byproduct of these reductions was to make the administration of qualified plans by employers much more complex. The traditional approach to pension tax reform focuses on these two related factors as the primary reason why the scope of pension coverage has become

6. Quantifying the amount of this "surplus" is somewhat of a moving target. The most recent estimate available as of the time this article went to press, was for a projected surplus of \$232 billion for fiscal year 2000. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, CHAP. ONE at p. 1 (July 2000) (available on-line at <http://www.cbo.gov>). This estimate was \$53 billion higher than the estimate given just three months before in April of 2000. *Id.* at Summary, Section 2, p. 1. I use the terms "deficit" and "surplus" throughout the article in the same way that lawmakers define these terms in the context of the federal budget balancing process. See discussion *infra* Part I.C.

stagnant. According to the logic of the traditional approach, reversing these trends will result in expanded pension plan coverage.

To date the traditional approach has dominated proposals for pension tax law reform. In Part IV I propose an alternative approach--the vision of "targeted pension reform." By "targeted pension reform" I mean pension tax law legislation that is designed to expand retirement plan coverage for rank-and-file workers and to enhance their opportunity to achieve an adequate retirement income.⁷ In the process, targeted pension reform would improve the distributional equities of the pension tax law system.

My legislative suggestions for achieving targeted pension reform, described in Part V of the article, are not novel. I propose that Congress should close, or at least narrow, the loopholes in the pension tax law system that reduce the scope of retirement plan coverage and benefits for rank-and-file workers. These loopholes are well-known to pension tax law experts. Despite this fact, none of the proposed pension reform legislation I discuss in Part III attempts to reform these loopholes. The fundamental obstacle to targeted pension reform appears to be the fear, based on the assumptions that underlie the traditional approach, that employers will respond by terminating retirement plans for their employees rather than expand the scope of coverage.⁸

The central premise of this article is that employers will not terminate their retirement plans in response to targeted pension reform. I argue that this fear of plan termination, which has stymied reform in the past, ignores the business context which shapes and influences the employer's voluntary decision to sponsor a retirement plan. This business context provides a much broader range of factors and incentives than the narrow view of employer behavior posited by the traditional approach.

Part IV analyzes and explains in detail why targeted pension reform will not trigger a counterproductive backlash of plan terminations by employers. Part IV draws upon the work of corporate governance scholars to develop an underlying theoretical foundation that justifies targeted pension reform. This approach, the "targeted reform theory," more realistically represents the employer's voluntary decision to sponsor a retirement plan by placing that decision in its appropriate business context. To date, corporate governance research has focused primarily on publicly traded corporations. This article expands the basic premise of corporate governance theory--that legal structure influences management behavior--to non-publicly traded businesses. My foundational theory answers two fundamental questions essential to designing effective legislation for targeted pension reform. First, what business-related factors will influence the employer's decision to sponsor a retirement plan? Second, what business-related factors will influence which employees are included and which employees are excluded from coverage under the employer's retirement plan?

7. Like many other scholars, I do not attempt to define what constitutes an "adequate retirement income." Commonly used standards vary from 60% to 100% of lost wages due to retirement. See Graetz, *supra* note 3, at 856, note 9 (100%); Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOYOLA L. REV. 1063, 1188 (1997) (80%); Jonathan Barry Forman, *Universal Pensions*, 2 CHAPMAN L. REV. 95 (1999) (60%-80%). Because "success" in achieving an adequate retirement income is a difficult concept to define or measure, I instead focus in the article on the one factor that may improve the income security of an individual's retirement--coverage under a private retirement plan.

8. See discussion *infra* Part III.A.

The targeted reform theory provides important insights for lawmakers interested in achieving targeted pension reform. Employer size is only a rough surrogate for the legal structure of the business entity. It is this legal structure and the resulting consequences for both taxation of business profits and entity governance that influence the employer's decision-making process for plan sponsorship and coverage design. Although all types of employers exclude workers from retirement plan coverage, the reasons they do so, and the methods they use, are not the same. Targeted pension reform legislation should be crafted accordingly.

Employee demand for retirement plans, or the lack thereof, is an important factor in the employer's voluntary decision to sponsor a retirement plan. Proposed legislation to increase IRA contribution limits is likely to undermine the goal of targeted pension reform because it reduces employee demand for employer-sponsored retirement plans. Similarly, proposed legislation to increase 401(k) salary deferral limits is likely to reduce employee demand for retirement plans requiring significant employer contributions. These insights are important ones for lawmakers to consider in fashioning targeted pension reform legislation. The workers most at risk for inadequate retirement income--lower-income workers--are those least able to afford to make contributions to an IRA or 401(k) plan. Lower-income workers will significantly improve their prospects for a financially secure retirement only once their employers decide to move beyond an employee-funded 401(k) plan and sponsor an employer-funded retirement plan.

Part V of the article proposes two guiding principles for drafting targeted pension reform legislation. First, Congress should develop legislation that reforms the loopholes in the pension tax system to broaden the scope of retirement plan coverage and benefits for rank-and-file workers. Second, Congress should focus on obstacles to and incentives for new plan sponsorship by employers that are the least susceptible to budgetary cycles. Part V discusses each of these general principles and illustrates them with specific examples and suggestions for targeted pension reform legislation. The article concludes with suggestions for completing a legislative agenda designed to achieve the objectives of targeted pension reform.

II. THE BUDGET PROCESS AND PENSION TAX POLICY CYCLES

A. Who Lacks Pension Coverage?

Critics of the pension tax laws often cite the statistic that the voluntary retirement plan system covers only 50% of the workforce.⁹ This criticism is somewhat misleading

9. See, e.g., Gordon P. Goodfellow & Sylvester J. Schieber, *Death and Taxes: Can We Fund for Retirement Between Them?*, in *THE FUTURE OF PENSIONS IN THE UNITED STATES*, 154 (Ray Schmidt ed. 1993); Alicia H. Munnell, *Are Pensions Worth the Cost?*, *NATIONAL TAX J.* 393 (1991); Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable As a Means of Increasing Retirement Income?* 49 *TAX L. REV.* 1, 4 (1993). On an aggregate basis the statistic is accurate. Although the absolute number of workers with pension coverage has increased steadily over time, the number of workers without pension coverage has grown at the same pace. See *PENSION AND WELFARE BENEFITS ADMINISTRATION*, U.S. DEPT. OF LABOR, *PRIVATE PENSION PLAN BULLETIN NO. 7*, *ABSTRACT OF 1994 FORM 5500 ANNUAL REPORTS* (Spring 1998) Graph E.3 at 95. As a result, no real progress has been made in

because it masks important differences in coverage patterns both among employers and among different types of workers.¹⁰

As an initial observation, employers having fewer than 100 employees ("smaller employers")¹¹ are much less likely to sponsor a retirement plan. Only 31% of individuals who work for smaller employers have a retirement plan.¹² In contrast, 85% of workers at employers having 100 or more full-time employees ("larger employers")¹³ have a retirement plan available to them.¹⁴ Not surprisingly, rates of participation in retirement plans are substantially lower for smaller employers. Only 46% of full-time employees of smaller employers participate in a retirement plan.¹⁵ In contrast, 79% of full-time employees of larger employers participate in a retirement plan.¹⁶ Participation rates also are markedly lower for part-time employees. Smaller employers offer retirement plan benefits to only 13% of their part-time employees.¹⁷ Larger employers provide retirement plan benefits to 34% of their part-time employees.¹⁸

Coverage rates for full-time and part-time employees also can be analyzed by the different occupations of workers who are covered by retirement plans. Blue collar and service employees, whether full-time or part-time, are much less likely to be offered retirement plan benefits than professional, technical, clerical and sales employees. Table

reducing the "gap" in overall retirement plan coverage, despite numerous attempts at reform of the pension tax laws. *See* discussion *infra* Part I C.

10. Another way to analyze private pension coverage is to study pension coverage from the life cycle perspective of the individual, rather than taking a "snapshot" of the workforce at a given point in time. *See* Goodfellow & Schieber, *supra* note 9, in *THE FUTURE OF PENSIONS* at 154. Goodfellow and Schieber have used this analytical approach and found that pension coverage rates increase steadily with age. *See id.* at 154-163. Even using this lifecycle approach, they still found "disturbing" that a comparison of individuals of the same age in 1980 and 1990 showed a significant reduction in pension participation rates. *See id.* at 158-59.

11. Throughout the article, the term "smaller employer" will refer to an employer having fewer than 100 full-time employees, and the term "larger employer" to refer to an employer having 100 or more full-time employees. My terminology corresponds to the categories used by the Bureau of Labor Statistics ("BLS") for data collection concerning retirement plan sponsorship and coverage. The BLS has collected and published data on employee benefits offered by private employers since 1979. The BLS surveys differentiate among employers according to the number of employees. The BLS defines "small" employers as having fewer than 100 employees. *See* BUREAU OF LABOR STATISTICS, *EMPLOYEE BENEFITS IN SMALL PRIVATE ESTABLISHMENTS*, 1996, iii (April 1999). [Hereinafter *SMALL ESTABLISHMENTS*]. The BLS defines medium and large employers as having 100 or more employees. *See id.*

12. Employee BENEFIT RESEARCH INSTITUTE, *The 1999 Small Employer Retirement Survey: Building a Better Mousetrap Is Not Enough*, Issue Brief No. 212, 3 (August 1999).

13. *See id.*

14. *Id.*

15. *SMALL PRIVATE ESTABLISHMENTS*, *supra* note 11, table 1 at 5. The reported data are for 1996. For 401(k) plans with no employer contribution, coverage data include only those workers who are actually making pre-tax contributions to the 401(k) plan. *Id.* at 80, note 35.

16. Bureau of Labor Statistics, *Employee Benefits in Medium and Large Private Establishments*, 1997, table 1 at 5 (Sept. 1999). The reported data are for 1997.

17. *SMALL PRIVATE ESTABLISHMENTS*, *supra* note 11, table 96 at 102.

18. *MEDIUM AND LARGE PRIVATE ESTABLISHMENTS*, *supra* note 16, table 192 at 153. The Internal Revenue Service has made clear that an employer cannot impose a "disguised" service condition for participants in qualified retirement plans in excess of 1,000 hours of service by excluding groups of workers on the basis of the employer's classification of them as "part-time" employees. *See* TAM 9508003; IRS Field Directive on Exclusion of Part-Time Employees. Such a disguised service requirement violates Code Section 410(a). *See* sources cited *supra*; Treas. Reg. § 1.410(a)-3(e), Example 3. For survey purposes the Bureau of Labor Statistics does not define "part-time employees," but rather uses each employer's own individual determination of which of its workers are "part-time" employees. *See* notes of conversation with Anne Foster, Bureau of Labor Statistics, National Compensation Survey (on file with the author).

1 below summarizes coverage rates by size of employer, full-time or part-time status, and occupation.

The general tendency of employers to exclude part-time and blue collar and service employees from retirement plan coverage has obvious and serious implications for national retirement policy.²⁰ A recent survey found that among persons who reported not yet having begun saving for retirement, 31% cited as a major reason that their employer did not offer them a retirement savings plan.²¹ Conversely, among persons who reported having begun to save for retirement, 48% cited the availability of a plan at work as giving them "a lot" of motivation to save for retirement.²² The significantly lower plan sponsorship and participation rates for smaller employers are particularly troublesome. Smaller employers constitute ninety-eight percent (98%) of all employers in the United States.²³ They employed thirty-eight million persons, accounting for 38% of all employment.²⁴

TABLE 1¹⁹

20. With the possible exception of unionized workers, blue-collar and service workers are likely to have lower career earnings, which translate into lower Social Security benefits and lower private savings rates. Although Social Security benefits are disproportionately weighted toward low earnings workers when measured on a money's worth basis, in absolute dollars even the maximum monthly benefit is relatively meager. See discussion *infra* notes 238 & 265.

21. Employee Benefits Research Institute, *The Evolution of Retirement: Results of the 1999 Retirement Confidence Survey*, Issue Brief No. 216, 11 (Dec. 1999). Other major reasons were: having other savings goals, such as a house or education (36%); expecting to have a pension (26%); lots of time remains until retirement (24%); not knowing where to start (18%); and Social Security will take care of them (16%). By far, however, the overwhelming major reason cited by non-savers (66%) was having too many current financial responsibilities.

Significantly, many of the major reasons given for not saving are influenced, directly or indirectly, by the employer's choice to sponsor a retirement plan. There is strong empirical evidence that where the employer sponsors a retirement savings plan for workers, the educational materials that oftentimes accompany the plan are effective in changing employee attitudes toward retirement savings and increasing retirement savings. See *The Evolution of Retirement*, *supra*, at 15-16; Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L. J. 1, 25 (2000).

22. *The Evolution of Retirement*, *supra* note 21, at 11. Other major factors motivating retirement savings were: feeling they could not count on Social Security (53%); starting to earn enough money to save for retirement (49%); having seen others not prepare and consequently struggle in retirement (48%); realizing time was running out to prepare for retirement (39%); the advice of a financial professional (24%); and a family event, such as marriage, birth of a child, or parents' retirement (21%). *Id.*

23. Employee Benefit Research Institute, *supra* note 12, at 3.

24. *Id.*

19. See SMALL PRIVATE ESTABLISHMENTS, *supra* note 11; tables 1, 96 at 5, 102; MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, *supra* note 16, tables 1, 192 at 5, 153. The BLS survey defined the three occupational groups as follows. Professional and technical workers include professional, technical, executive, administrative, managerial, and related occupations. Clerical and sales workers include clerical, administrative support, and sales occupations. Blue-collar and service workers include precision production, craft and repair occupations, machine operators and inspectors, transportation and moving occupations, handlers, equipment cleaners, helpers and laborers, and service occupations. SMALL PRIVATE ESTABLISHMENTS, Appendix A: Technical Note, at 104. The much higher rate of coverage among blue-collar and service workers of larger employers is very likely attributable to higher rates of unionization, and thus participation in collectively bargained multi-employer retirement plans, for this group. See 1994 FORM 5500 ANN. REP., *supra* note 9, Tables B.3 at 16, B.4 at 17, and B.6 at 19.

COVERAGE RATES BY OCCUPATION
Smaller Employers (fewer than 100 employees)

	Professional/ Technical	Clerical/ Sales	Blue-Collar/ Service
Full-Time Workers	56%	53%	37%
Part-Time Workers	22%	24%	6%

Larger Employers (100 or more employees)

	Professional/ Technical	Clerical/ Sales	Blue-Collar/ Service
Full-Time Workers	89%	81%	72%
Part-Time Workers	47%	40%	26%

Finally, the coverage data may mask potential gender and racial inequities in the scope of private retirement plan coverage. Women and minority workers have a greater tendency to be employed in smaller firms, to hold lower wage jobs, and to work less than full-time. These factors, along with higher employment turnover rates, contribute to lower pension coverage rates for women and minority workers.²⁵

Who lacks pension coverage? To answer the question posed by this section, persons without pension coverage can be broadly characterized as falling into two main groups.²⁶

25. Goodfellow and Schieber characterize their findings concerning pension coverage rates for women as optimistic because their data indicate that younger women, who are entering the workforce in greater numbers, will have a corresponding increase in their rates of pension coverage. See Gordon P. Goodfellow & Sylvester J. Schieber, *The Role of Tax Expenditures in the Provision of Retirement Income Security*, in PENSIONS IN A CHANGING ECONOMY, CHAP. 7, 89 (Richard V. Burkhauser & Dallas L. Salisbury, eds. 1993). Korczyk also has analyzed pension coverage rates and found that women have made progress in obtaining pension coverage. As a population, however, pension coverage rates for women still lag behind those for men. See Sophie M. Korczyk, *Gender Issues in Employer Pensions Policy*, in PENSIONS IN A CHANGING ECONOMY, CHAP. 5, 59-65. Snyder has analyzed pension coverage by race. See Donald C. Snyder, *The Economic Well-Being of Retired Workers by Race and Hispanic Origin*, in PENSIONS IN A CHANGING ECONOMY, CHAP. 6, 67-78. Both Korczyk and Snyder conclude that the tendencies of women and minority workers to be employed in smaller firms, to have lower wage jobs, and to have higher turnover rates contribute to their overall lower rates of pension coverage. See generally Employee Benefits Research Institute, *Retirement Planning and Saving Among Women: Results From the 1999 Women's Retirement Confidence Survey*, 21 NOTES 1-6 (Jan. 2000); *The Evolution of Retirement*, *supra* note 21, at 17-20 (discussing survey results for African-Americans, Hispanic-Americans, and Asian-Americans). For an analysis of gender bias in the pension tax laws and subsequent attempts at reform, see Camilla E. Watson, *The Pension Game: Age and Gender-Based Inequities In the Retirement System*, 25 GA. L. REV. 1-69 (1990), and Dana M. Muir, *From YUPPIES to GUPPIES: Unfunded Mandates and Benefit Plan Regulation*, 34 GEO. L. REV. 195, 215-223 (1999).

26. An argument could be made that "contingent workers" constitute a third group of persons with low pension coverage rates. See Employee Benefits Research Institute, *Contingent Workers and Workers In Alternative Work Arrangements*, Issue Brief No. 207 (Mar. 1999) (defining contingent work as covering "flexible employment practices such as temporary work, employee leasing, self-employment, contracting, and home-based work, as well as part-time work.") I choose not to address this group for three reasons. First, persons in contingent work arrangements constitute only a small percentage of the total workforce. See *id.* at 4. Second, there is a large amount of overlap between part-time and low-income employees and the contingent and alternative work arrangement population. See *id.* at 3. Third, the problem of the misclassification of employees as independent contractors and the legal characterization of leased employees in tripartite work arrangements

One group consists of employees of smaller employers who do not sponsor retirement plans for their workers. The other group consists of part-time and low-skilled workers (collectively referred to in the remainder of this article as "low-income workers").²⁷

B. Overview of the Tax Laws Governing Pension Coverage and Benefits

The single most distinguishing characteristic of the American retirement plan system created by the Employee Retirement Income Security Act of 1974²⁸ ("ERISA") is that plan sponsorship is *voluntary* among employers.²⁹ Significant tax benefits are used to motivate employers to sponsor retirement plans and to include rank-and-file workers in those plans.³⁰ To qualify for these tax benefits, the employer's retirement plan must be designed to satisfy numerous technical requirements contained in Section 401(a) of the Internal Revenue Code.³¹

There are two main sets of rules that employers can use to exclude certain groups of employees from participating in the employer's retirement plan. *Eligibility rules* govern which employees the employer must treat as eligible to be included in the employer's retirement plan.³² *Coverage rules* (sometimes referred to as part of the *nondiscrimination rules* for qualified plans)³³ tell the employer how many individuals, among the pool of otherwise eligible employees, the employer may exclude from coverage under the plan.³⁴ The eligibility and coverage rules, taken together, dictate how many of its workers the employer can exclude from retirement plan coverage and still have the plan qual-

raises unique issues that are beyond the scope of this article. See Alvin D. Lurie, *Microsoft Re-re-redux: New Twist of the Eternal Triangle*, TAX NOTES, 143-151 (July 5, 1999).

27. I have deliberately used the term "low-income workers" to describe this second group rather than the Bureau of Labor Statistics nomenclature of "blue-collar and service employees." Other scholars too have found the "low-income" classification useful, particularly when analyzing pension coverage and the associated distribution among income groups of the pension tax expenditure. See, e.g., Sylvester Schieber & Gordon Goodfellow, *Fat Cats, Bureaucrats, and Common Workers: Distributing the Pension Tax Preference Pie*, in PENSION FUNDING AND TAXATION, CHAP. VI, at 112-113 (Dallas L. Salisbury & Nora Super Jones, eds. 1994); Dallas L. Salisbury, *The Costs and Benefits of Pension Tax Expenditures*, in PENSION FUNDING & TAXATION, *supra*, CHAP. V, at 94-95 and Table 5.7; Goodfellow & Schieber, *supra* note 25, at 92-93.

28. See Pub. L. No. 93-406, 88 Stat. 829 (1974).

29. See H.R. REP. NO. 93-533, 1 ("[T]he committee has been constrained to recognize the voluntary nature of private retirement plans.").

30. See Staff Report of the Joint Committee on Taxation, Overview of Present-Law Tax Rules and Issues Relating to Employer-Sponsored Retirement Plans, Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, at 5 (March 22, 1999) In a qualified retirement plan, the employer receives an immediate deduction for its contributions to the plan (including 401(k) plan salary deferral contributions), within specified limits. The employee, however, is not taxed on this contribution and any earnings thereon until the funds are distributed out of the plan. See Halperin, *supra* note 9 at 12-13. Contrary to popular perception, for defined contribution and 401(k) plans the real economic advantage of this tax deferral for the employee lies not in the deferral of immediate income taxation but rather in the employee's ability to earn a pre-tax rate of return for a number of years prior to retirement. See Halperin, *supra* note 9, at 2 & note 4.

31. See I.R.C. § 401(a) (1994 & Supp. IV 1998).

32. See I.R.C. § 410(a) (1994).

33. The other component of the nondiscrimination rules is Code Section 401(a)(4), which prohibits discrimination in favor of highly-compensated employees in the contributions or benefits provided under the plan. See I.R.C. § 401(a)(4) (1994); Treas. Reg. § 1.401(a)-4.

34. See I.R.C. § 410(b) (1994); Treas. Reg. § 1.410(b).

ify for preferential treatment under the pension tax law system.³⁵ The employer is free, of course, to design a plan that is more generous in the scope of its coverage--but few employers choose to do so.³⁶

1. Eligibility Rules

The employer can treat an employee as ineligible for the employer's retirement plan until the employee has satisfied two eligibility criteria. First, the plan can be designed so that all employees under the age of 21 are ineligible.³⁷ Second, the plan can be designed so that a new or rehired employee is ineligible to participate in the plan until he has completed one year of service.³⁸

For transient workers who participate in defined contribution plans, the one year of service rule can greatly reduce their retirement savings.³⁹ This reduction is particularly acute for participants in 401(k) plans.⁴⁰ For example, a 22-year-old who contributes \$4,000 each year to a 401(k) plan until age 62 will have accumulated \$1.1 million in retirement savings, assuming an eight percent annual rate of return.⁴¹ But if that worker changes jobs seven times during the course of her career and must sit out a year each time before becoming eligible to participate in the employer's 401(k) plan, she will have accumulated just \$534,000 in her retirement savings account by age 62.⁴² The difference, much more than the \$28,000 in lost contributions, is attributable to the lost economic benefit of pre-tax compounding of earnings inside the plan.⁴³

Most employers require some minimum service period before a new or rehired employee becomes eligible to participate in the employer's retirement plan.⁴⁴ The average length of service requirement for 401(k) plans is over ten months.⁴⁵ Similarly long service periods apply to other types of defined contribution plans.⁴⁶ Many employers re-

35. See I.R.C. § 401(a)(3) (1994).

36. See discussion *supra* Part I.A.

37. I.R.C. § 410(a)(1)(A)(i) (1994). This ineligibility period can be extended to age 26 for employees of educational institutions. See I.R.C. § 410(a)(1)(B)(ii) (1994).

38. I.R.C. § 410(a)(1)(A)(ii) (1994). A year of service is defined as 1,000 hours of service completed during the 12-month period beginning with the employee's employment commencement date. I.R.C. § 410(a)(3)(A) (1994). Special rules apply to seasonal and maritime industries. See I.R.C. § 410(a)(3)(B),(D) (1994). An employer can extend the one year of service requirement to up to two years if the employee becomes 100% vested upon entering the plan. See I.R.C. § 410(a)(1)(B)(i) (1994).

³⁹The one year of service rule does not delay the time for vesting. See I.R.C. § 411(a)(4) (1994 & Supp. IV 1998). It is therefore less detrimental to participants in defined benefit plans.

40. The growing importance of defined contribution plans in general, and 401(k) plans in particular, is well-documented. See Medill, *supra* note 21, at 7-9. In 1995, 401(k) plan contributions accounted for 55% of all contributions to employer-sponsored retirement plans. See *Stretching the Pension Dollar: Improving U.S. Retirement Security and National Savings by Enhancing Employer-Based Pensions*, (Watson Wyatt Worldwide, Research and Information Center, Aug. 1999, at 9) (prepared for the American Council for Capital Formation and the Association of Private Pension and Welfare Plans).

41. Jeannie Mandelker, *Empowered Employees*, CFO MAG., 74 (April 1999).

42. See *Id.*

43. See discussion and sources cited *supra* note 30.

44. See SMALL PRIVATE ESTABLISHMENTS, *supra* note 11, tables 84 and 86 at 85, 86; MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, *supra* note 16, Tables 168, 173, and 176 at 130, 132 and 134.

45. See SMALL PRIVATE ESTABLISHMENTS, *supra* note 11, Table 86 at 86; MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, *supra* note 16, Table 176 at 134.

46. See SMALL PRIVATE ESTABLISHMENTS, *supra* note 11, Table 84 at 85; MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, *supra* note 16, Tables 168 and 173 at 130 and 132.

quire the maximum one year of service for plan eligibility.⁴⁷

2. Coverage Rules

The coverage rules are contained in Section 410(b) of the Internal Revenue Code,⁴⁸ and further elaborated in Treasury Department Regulations.⁴⁹ The purpose of the coverage rules "is to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees."⁵⁰ Several compliance options are available to employers.⁵¹ All of these options are calculated using only the pool of eligible employees who already have satisfied the plan's eligibility rules.⁵²

The simplest option is known as the *ratio percentage test*.⁵³ Under the ratio percentage test, the employer's plan satisfies the minimum coverage requirement if the plan benefits a percentage of "non-highly compensated employees"⁵⁴ that is at least 70% of the percentage of "highly compensated employees"⁵⁵ benefitting under the plan.⁵⁶ Example 1 below illustrates how the ratio percentage test works, and the interplay between the eligibility and coverage rules.

Example 1

A business has a total of 11 employees, consisting of one highly compensated employee (the owner), and 10 non-highly compensated employees. Eight of the 10 non-highly compensated employees are salaried computer programmers; two are hourly office personnel. All 11 employees have satisfied the plan's eligibility rules (age 21 with one year of service).

47. See sources cited *supra* notes 44-46. A 1999 survey by the Profit Sharing/401(k) Council of America, limited to its member companies, found that although the most frequent eligibility period for 401(k) and profit-sharing plans still was one year, there was a trend toward more immediate eligibility. See Profit Sharing/401(k) Council of America, *401(k) and Profit Sharing Plan Eligibility Survey* (Dec. 1999) available at <<http://www.psc.org>>.

48. See I.R.C. § 410(b) (1994).

49. See Treas. Reg. § 1.410(b) (as amended in 1994).

50. Overview of Present-Law Tax Rules, *supra* note 30, at 2.

51. See I.R.C. § 410(b) (1994).

52. See *Overview of Present-Law Tax Rules*, *supra* note 30, at 8. Union employees are excluded from the pool of eligible employees if retirement benefits were the subject of good faith bargaining between the employer and the union. See I.R.C. § 410(b)(3)(A) (1994).

53. See Treas. Reg. § 1.410(b)-2(b)(2) (as amended in 1994). For numerical illustrations of the ratio percentage test, the reader may refer to the examples found in the Treasury Department Regulations, Treas. Reg. § 1.410(b)-2(b)(2)(ii), and in JOHN H. LANGBEIN & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW*, 284 (3RD ED. 2000).

54. A non-highly compensated employee is any employee who is not a highly compensated employee. See *infra* note 55.

55. A highly compensated employee is any employee who was a 5% owner of the employer during the current or preceding year, or who for the preceding year had compensation in excess of \$80,000 (indexed) and, if the employer so elects, was in the top 20% of all employees ranked by compensation. See I.R.C. § 414(q)(1)-(3) (1994 & Supp. IV 1998). For 2000 the indexed income limit was \$85,000. See source cited *infra* note 150.

56. See *Overview of Present-Law Tax Rules*, *supra* note 30, at 9. For 401(k) plans, an employee is treated for coverage purposes as "benefitting" under the 401(k) plan if the employee is *eligible* to make elective salary deferrals, whether or not the employee actually does so. See I.R.C. § 410(b)(6)(E) (1994).

The owner designs the plan to cover all salaried employees and exclude from coverage all hourly employees (thereby including the salaried computer programmers and excluding the hourly office personnel). The plan covers 100% (1/1 HCEs) of the highly compensated employees. Under the ratio percentage test it must cover 70% ($100\% \times 70\%$) of the non-highly compensated employees. The plan covers 80% (8/10 non-HCEs) of the non-highly compensated employees. It easily passes the ratio percentage test.

What happens if the employer adds another hourly employee? For the first year after the new hourly employee is hired, she is ineligible to participate in the employer's plan. Thus the employer's coverage percentage of non-highly compensated employees remains unchanged at 80%. Once the new hourly employee has satisfied the plan's one year of service requirement; however, the plan's coverage percentage of non-highly compensated employees decreases to 72.7% (8/11 non-HCEs).

What happens if two of the computer programmers terminate employment? The employer's plan now fails the ratio percentage test. Even if two new computer programmers are hired, they will not be eligible for the plan until they have completed a year of service. During that year, the plan will cover only 66% (6/9) of the employer's non-highly compensated employees.

Contrast the example of this very small employer with Example 2 of the much larger employer below:

Example 2

A business has a total of 1,010 employees, consisting of ten highly compensated employees and 1,000 non-highly compensated employees. Of the 1,000 non-highly compensated employees, 600 are salaried workers and 400 are hourly workers. All 1,010 employees have satisfied the plan's eligibility rules (age 21 with one year of service).

Seven of the ten of the highly compensated employees are covered by the plan.⁵⁷ Of the non-highly compensated employees, the plan covers only the 600 salaried employees and excludes the 400 hourly employees. Does this plan pass the ratio percentage test? Yes. Seventy percent (7/10) of the employer's highly compensated employees benefit under the plan. Therefore, the plan must benefit 49% ($70\% \times 70\%$) of the employer's non-highly compensated employees. This plan benefits 60% (600/1000) of the employer's non-highly compensated employees, and therefore passes the ratio percentage test.

My examples illustrate for the reader the dynamics of the ratio percentage test. The retirement plans of smaller employers tend to be more sensitive to employee turnover. Retirement plans sponsored by larger employers are less vulnerable to employee turnover among the ranks of non-highly compensated employees. In addition, larger employers can further reduce the number of non-highly compensated employees that must benefit under the plan by excluding some management executives and offering to them

57. The employer may prefer to give these three highly compensated employees a more lucrative nonqualified deferred compensation plan ("nonqualified plan") instead of allowing them to participate in the employer's retirement plan. Because payment of benefits from a nonqualified plan depends on the continued financial solvency of the employer, such plans are often more attractive to employees of larger and more established employers. See generally Halperin, *supra* note 9, at 24-27.

instead alternative compensation arrangements.⁵⁸

The second, more complex option an employer may use to satisfy the coverage rules is the *average benefits test*.⁵⁹ Under the average benefits test, the employer's plan must satisfy two criteria. First, the plan's method for classifying who is a covered employee cannot discriminate in favor of highly-compensated employees ("nondiscriminatory classification test").⁶⁰ This component of the average benefits test addresses the coverage percentage of non-highly compensated employees.⁶¹ Second, the average benefit percentage for all non-highly compensated employees of the employer must be at least 70% of the average benefit percentage for all highly-compensated employees of the employer ("average benefit percentage test").⁶² Under the average benefits test, the employer's plan can satisfy the minimum coverage requirement of Code Section 410(b) with a much lower coverage rate for non-highly compensated employees than under the ratio percentage test.⁶³ Example 3 below illustrates the difference in scope of coverage that is possible between the ratio percentage test and the average benefits test.

Example 3

A business has a total of 1010 employees, consisting of 10 highly compensated employees and 1000 non-highly compensated employees. Of the 1000 non-highly compensated employees, 200 are salaried and 800 are hourly employees. All 1010 employees have satisfied the plan's eligibility requirements (age 21 with one year of service). The plan covers only salaried employees. Seven of the ten highly compensated employees (all salaried employees) are covered by the plan. Of the 1000 non-highly compensated employees, the 200 salaried employees are included in the plan and the 800 hourly employees are excluded from participation. The plan's ratio percentage is only 28.5%.⁶⁴

58. See discussion *supra* note 57 and accompanying text.

59. See L.R.C. § 410(b)(2) (1994). For numerical illustrations of the average benefits test, the reader may refer to the examples found in Treasury Department Regulations, Treas. Reg. 1.410(b)-4 and 1.410(b)-5, and LANGBEIN & WOLK, *supra* note 53, at 284-86.

60. Overview of *Present-Law Tax Rules*, *supra* note 30, at 8; see Treas. Reg. § 1.410(b)-4. (nondiscriminatory classification component of average benefits test).

61. See Treas. Reg. § 1.410(b)-4.

62. See Treas. Reg. § 1.410(b)-5 (average benefit percentage component of average benefits test). These average benefit percentages are calculated using all employees of the employer, whether or not they are covered by a plan. See Peter J. Wiedenbeck, *Nondiscrimination in Employee Benefits: False Starts and Future Trends*, 52 TENN. L. REV. 167 (1985), reprinted in PETER J. WIEDENBECK & RUSSELL K. OSGOOD, *CASES AND MATERIALS ON EMPLOYEE BENEFITS*, 212 (1996).

63. See DAN M. MCGILL, ET AL., *FUNDAMENTALS OF PRIVATE PENSIONS*, 69 (7th Ed. 1996). In general, the greater the percentage of non-highly compensated employees in the employer's workforce, the easier it is for the employer to pass the nondiscriminatory classification component of the average benefits test. See MCGILL, *supra*, at 69. Typically a plan using the average benefits test will have more difficulty passing the average benefit percentage component than the nondiscriminatory classification component of the test. See LANGBEIN & WOLK, *supra* note 53, at 285-86 (describing employer's options for passing the average benefit percentage component of the average benefits test). See generally Treas. Reg. § 1.410(b)-4.

64. For the reader who wants to do the math, the plan's ratio percentage is calculated by dividing the coverage percentage of the non-highly compensated employees by the coverage percentage of the highly compensated employees. See Treas. Reg. § 1.410(b)-4(c)(5), Example 1. In my example, the non-highly compensated coverage percentage is 20% (200/1000) and the highly compensated employee coverage percentage is 70% (7/10). This results in a ratio percentage of 28.5% (20%/70%).

Under the nondiscriminatory classification component of the average benefits test, this plan comfortably passes by a margin of almost 8%.⁶⁵

Employers with a division or subsidiary having at least 50 employees can use a special-purpose rule known as the *separate line of business* (SLOB) test.⁶⁶ The separate line of business test can be used to satisfy the Code Section 410(b) minimum coverage requirement when the employer offers a separate qualified plan limited to the employees of a separate subsidiary or division ("SLOB entity"). The SLOB entity must satisfy a complex set of criteria defined by regulation.⁶⁷ The traditional policy justification for the SLOB exception is that the exemption is necessary to preserve flexibility and competitiveness for larger employers with multiple lines of business.⁶⁸ These larger employers otherwise may not be able to compete with other employers in a single line of business where the industry practice is not to sponsor a retirement plan for their workers.⁶⁹ The regulatory requirements of the SLOB test, however, do not require a showing of competitive need justifying a separate plan for the subsidiary or divisional group.⁷⁰

Both the average benefits and SLOB tests are much more complex for the employer to implement and administer, oftentimes requiring the assistance of highly skilled pension tax law experts. The advantage to the employer of using these more complex tests is calculated in terms of dollars saved from excluding even more employees from the plan coverage than would be possible under the ratio percentage test. Consequently, these tests tend to be most popular among larger employers who will generate significant cost savings if they can exclude large numbers of employees from coverage under a generous company retirement plan.

3. Limitation Rules

Current legislative proposals to reform the pension tax laws, discussed in Part II, do not focus on amending the eligibility and coverage requirements for qualified retirement plans.⁷¹ Instead, these proposals would increase the maximum limitations for deductions, contributions and benefits from qualified retirement plans (collectively, the *limitation rules*).⁷² In addition, these proposals would increase the maximum contribution limits for deductible⁷³ and so-called "Roth"⁷⁴ individual retirement accounts ("IRAs").

The underlying purpose of the limitation rules for qualified plans is simple--to limit the amount of the tax subsidy for qualified retirement plans. In 2000, for defined contribution plans the maximum amount that could be deducted annually by the employer for

65. See Treas. Reg. § 1.410(b)-4(c) (as amended in 1991). In my example, the non-highly compensated employee concentration percentage is 99% (1000 non-highly compensated employees/1010 total employees). At this level the plan's safe harbor ratio percentage is 20.75%. See *id.* Of course, the plan will not be qualified unless it also can pass the average benefit percentage component of the average benefits test. See Treas. Reg. § 1.410(b)-5; see sources cited *supra* notes 62-63.

66. I.R.C. §§ 410(b)(5) (1994); 414(r) (1994 & Supp. IV 1998).

67. See Treas. Reg. § 1.414(r).

68. See LANGBEIN & WOLK, *supra* note 53, at 301; Halperin, *supra* note 9, at 39-40.

69. See LANGBEIN & WOLK, *supra* note 53, at 301.

70. See Treas. Reg. § 1.414(r) (as amended in 1994).

71. See discussion *infra* Part II.A.

72. See I.R.C. § 404(a) (West 1999); I.R.C. § 415 (1994 & Supp. IV 1998).

73. See I.R.C. § 408(a) (1994).

74. See *id.*

each participant was the lesser of 25% of compensation (calculated on a maximum base compensation amount of \$170,000)⁷⁵ or \$30,000.⁷⁶ The maximum limit in 2000 for salary deferral contributions to a 401(k) plan was \$10,500.⁷⁷ For defined benefit plans, the limit on the annual benefit payable to each participant was the lesser of 100% of average compensation or \$130,000.⁷⁸ Beginning in 2000 there is no longer an overall combined limit for participants in both defined contribution and defined benefit plans.⁷⁹

The maximum annual contribution limit in 2000 for both traditional and Roth IRAs was \$2,000.⁸⁰ The difference between the two types of IRAs lies in the income tax treatment of contributions and withdrawals. Contributions to traditional IRAs are deductible by individuals; contributions to Roth IRAs are not.⁸¹ Contributions and investment earnings from traditional IRAs are includible in the individual's gross income when withdrawn. Withdrawals of contributions and investment earnings from Roth IRAs generally are not subject to federal income tax.⁸²

C. The Congressional Budget Act of 1974 and Its Effect on Pension Tax Policy

Congress enacted both the Congressional Budget and Impoundment Control Act⁸³ ("Budget Act") and ERISA in 1974. It is ironic indeed that the purposes and objectives of these two laws have become so entangled.

1. The Role of the Tax Expenditure Concept in the Budget Process

Many scholars have criticized how the changes to the appropriations process initiated by the Budget Act have changed the way Congress makes tax policy.⁸⁴ Although

75. See I.R.C. § 401(a)(17) (1994 & Supp. IV 1998); 404(a)(7) (1994). For figures for 2000 adjusted for inflation, see source cited *infra* note 150.

76. See OVERVIEW OF PRESENT-LAW TAX RULES, *supra* note 30, at 13; Carl Goldfield, *Employee Plans--Deductions, Contributions and Funding*, 371-3rd TAX MGMT. PORT, A-84, A-92 (1996). The \$30,000 limitation amount is not indexed for inflation.

77. See source cited *infra* note 150. Under the special nondiscrimination rules applicable to 401(k) plans, highly compensated employees may not be able to defer the maximum amount. See OVERVIEW OF PRESENT-LAW TAX RULES, *supra* note 30, at 12 (describing the actual deferral percentage ("ADP") test). For SIMPLE 401(k) plans, described *infra* Part I.C., the maximum deferral amount is \$6,000. See § 408(p)(2)(A)(ii) (1994 & Supp. IV 1998). Highly compensated employees in SIMPLE 401(k) plans and so-called "safe harbor" 401(k) plans with specified levels of employer matching contributions are exempt from ADP testing and therefore may defer the maximum amount allowed by law. See I.R.C. § 401(k)(11)-(12) (1994 & Supp. IV 1998).

78. See OVERVIEW OF PRESENT-LAW TAX RULES, *supra* note 30, at 14.

79. *Id.*

80. I.R.C. §§ 408(a)(1) (1994) (traditional IRAs); 408A(a) (Supp. IV 1998) (Roth IRAs). An individual can contribute to both a traditional IRA and a Roth IRA, but the aggregate total of his annual contributions cannot exceed \$2,000. See I.R.C. § 408A(c) (1994 & Supp. IV 1998). Income limits restrict eligibility for both deductible and Roth IRAs.

81. Compare I.R.C. § 219(b), (g) (1994 & Supp. IV 1998) with § 408A(c)(1).

82. Compare I.R.C. § 408(d)(1) with § 408A(d)(1)(a).

83. Pub. L. No. 93-344, 88 Stat. 297.

84. See, e.g., Michael J. Graetz, *Paint-By-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609-682 (1995); Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25-95 (1989); Michael A. Livingston, *Re-Inventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy*, 83 CORNELL L. REV. 365, 389 (1998) ("tax policy as a whole has increasingly become a subdivision

the details of the laws governing today's budget process are complex,⁸⁵ the basic idea is simple. Congress sets budgetary targets for revenues and spending.⁸⁶ Budgets also are estimated for various "tax expenditures,"⁸⁷ the catch-all term for tax revenues that are "lost" to the fisc due to preferential tax treatment of certain economic activities under the Internal Revenue Code.⁸⁸ If Congress increases spending in one area, it must either cut an equivalent amount of spending from somewhere else in the budget, or increase tax revenues. Conversely, if Congress wants to cut taxes, it must either reduce spending by a corresponding amount or increase tax revenues in another area so that the overall budgetary effect of tax reforms is "revenue-neutral."⁸⁹ In either instance, the list of estimated tax expenditures becomes the prime "hit list" for lawmakers looking for ways to finance proposed legislation.⁹⁰

of broader budgetary politics. . ."); but see Sheldon D. Pollack, *A New Dynamics of Tax Policy?*, 12 AM. J. TAX POL. 61 (1995) (attributing the "erratic and unusual pattern" of tax policy in the 1980s to structural changes in the American political system).

Graetz examines in detail how lawmakers use and rely upon the fiscal estimates required under today's budget appropriations process. Graetz strongly criticizes the current system because it focuses lawmakers on numerical revenue and expenditure estimates rather than the more important tax policy issues of distributional equity and long-term economic effects. See Graetz, *supra*, at 612-13. He concludes that "current practices of relying solely on five-or-ten-year annual revenue estimates and of fashioning tax legislation to achieve a particular result in a distribution table create an illusion of precision when such precision is impossible." See *id.* at 613.

85. The Balanced Budget and Emergency Deficit Control Act of 1985 (commonly known as "Gramm-Rudman"), Pub. L. No. 99-177, 99 Stat. 1037, refined the Budget Act's new appropriations process. The Budget Enforcement Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (Title XIII of the Omnibus Budget Reconciliation Act of 1990), revised the Gramm-Rudman procedures and imposed statutory caps on budget authority and outlays. The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, extended the caps through 1998. The Balanced Budget Act of 1997, Pub. L. No. 105-33, 111 Stat. 251, updated and extended the caps through 2002.

86. See 2 U.S.C. § 632; Graetz, *supra* note 84, at 611-12; McLure, *supra* note 84, at 32-33.

87. See 2 U.S.C. § 632(e)(6); McLure, *supra* note 84, at 32.

88. Section 3 of the Budget Act defines the term "tax expenditures" as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income, or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." 2 U.S.C. § 622(3).

Tax scholars have long debated the appropriate definition and scope of tax expenditures. See, e.g., Boris I. Bittker, *A "Comprehensive Tax" Base as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925-85 (1967); Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244-61 (1967); Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget--Response to Professor Bittker*, 22 NAT'L TAX J. 528-37 (1969); Boris I. Bittker, *The Tax Expenditure Budget--A Reply to Professors Surrey & Hellmuth*, 22 NAT'L TAX J. 538-41 (1969); Livingston, *supra* note 84, at 375-76. In particular, scholars have debated whether the tax preferences for retirement plans should be abhorred as a pejorative deviation from the normative Haig-Simons income tax base, or applauded as consistent with a consumption-based income tax. See Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315-65 (1988); Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POLICY 225-56 (1991); Edward A. Zelinsky, *Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein*, 9 AM. J. TAX POLICY 257-82 (1991); Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790, 831 & note 146 (1988). But see James A. Wooten, *The "Original Intent" of the Federal Tax Treatment of Private Pension Plans*, 85 TAX NOTES 1305-9 (1999). In this article I wish to avoid this theoretical debate concerning whether the preferential tax treatment for retirement plans is properly classified as a tax expenditure and simply treat it as such, because this is how lawmakers treat it for budgetary purposes.

89. See McLure, *supra* note 84, at 38-41; 81-82. Academics recognize this situation as creating a "zero-sum game." See *id.* at 39, but see Pollock, *supra* note 84, at 91-94 (disagreeing with characterization of tax policy making process under balanced budget constraints as a zero-sum game).

90. See McLure, *supra* note 84, at 33, note 21.

The subsidy for retirement plans sits atop the tax expenditure list.⁹¹ The sheer magnitude of the subsidy for retirement plans makes it highly susceptible to "reform" amendments designed to reduce the tax expenditure and thereby increase tax revenues.⁹² The estimated tax expenditure for retirement plans for 2000 was \$78.3 billion.⁹³ By way of comparison, the second and third largest tax expenditures for that year were for employer-provided health and long-term care insurance (\$61.3 billion) and the home mortgage interest deduction (\$50.4 billion).⁹⁴

Congress has not consciously undermined the private retirement plan system. But many experts have argued that the almost annual passage of pension tax legislation in the 1980s and early 1990s, designed to reduce the pension tax expenditure and meet overall budget deficit reduction targets, has had this effect.⁹⁵

91. See Staff of the Joint Committee on Taxation, 105th Cong., Estimates of Federal Tax Expenditures for Fiscal Years 1999-2003, at 15-24, Table I (Joint Comm. Print. 1998).

92. See Nancy J. Altman, Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security, 42 TAX L. REV. 435, 441 (Spring 1987); Goodfellow & Schieber, *supra* note 25, at 79-81.

93. Estimates of FEDERAL TAX EXPENDITURES, 1999-2003, *supra* note 91, table 1. The tax expenditures for IRAs (\$12.4 billion) and Keogh plans for self-employed individuals (\$5.1 billion) were comparably insignificant. See *id.* There is a popular misconception, perpetuated by lawmakers, that the entire amount of the pension tax expenditure goes toward subsidizing private employer-sponsored retirement plans. See EMPLOYEE BENEFITS RESEARCH INSTITUTE, FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS, 440 (5th Ed. 1997). In fact, slightly more of the pension tax expenditure is allocated to public sector retirement plans (54%) than is allocated to private sector retirement plans (46%). See *id.* at 439 (estimates using 1996 data).

The magnitude of the pension tax expenditure has prompted many scholars to question whether, as a matter of public policy, this subsidy can be justified. These criticisms fall into two main categories. First, some question the pension tax expenditure on equitable distribution grounds, arguing that the benefits of the subsidy are skewed in favor of high income taxpayers. See, e.g., Alicia H. Munnell, *Are Pensions Worth the Cost?*, NAT'L TAX J. 393-404 (Sept. 1991); *Concurrent Resolution on the Budget For Fiscal Year 1994: Hearings Before the Committee on the Budget, United States Senate*, 103d Cong., 1st Sess. 344 (1993) (statement of Dr. Jane G. Gravelle, policy analyst); Graetz, *supra* note 3, at 678-79. More recent analysis, however, indicates that one effect of the pension tax law reforms in the 1980s was a more equitable distribution of the pension tax expenditure among income classes. See discussion *infra* Part II.B.1.

Joseph Bankman has questioned the economic utility of the coverage rules, which "force" rank-and-file employees to save for retirement by requiring their employer to include them in the employer's qualified plan. See Joseph Bankman, *The Effect of Anti-Discrimination Provisions on Rank-and-File Compensation*, 72 WASH. U. L. REV. 597-618; Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790, 805-814 (1988). Writing in 1988, Bankman acknowledged that the pension tax expenditure may be justifiable on social policy grounds, particularly if rank-and-file employees are shown to be incapable of rational economic behavior. See Bankman, *supra*, 55 U. CHI. L. REV. at 814-21; see also Stein, *supra* note 88, at 227, note 10. Today there is highly persuasive empirical research indicating that the subsidy for retirement plans is justifiable on paternalistic grounds. Many employees lack the knowledge and ability to competently plan and prepare for their own retirement. See Medill, *supra* note 21, at 14-17.

94. Estimates of Federal Tax Expenditures, 1999-2003, *supra* note 91, at table 1.

95. See, e.g., Overview of Present-Law Tax Rules, *supra* note 30, at 16-17; Thomas Paine, Appraising Public Policy for Private Retirement Plans, in PENSION FUNDING & TAXATION, *supra* note 29, 1-2; Stretching the Pension Dollar, *supra* note 40, at i. Goodfellow and Schieber compared the pension coverage rates among workers of the same age for 1980 and 1990. They found that the scope of pension coverage had declined, despite a steady stream of pension reform legislation during this period. See Goodfellow & Schieber, *supra* note 25, at 83. The frustration of pension tax law experts who must implement these annual "reforms" is described by Robert E. Helm and Brian P. Goldstein in their article, Pension Reform/Simplification--An Urgent Need: Practical Proposals From the Front Lines, 25 GA. L. REV. 91-116 (1990).

2. The Pension Law Deficit Cycle: 1982 - 1995

Faced with large budget deficits, in 1982 Congress began a pattern of "reforming" the pension tax laws and the tax laws governing IRAs to curtail the associated tax subsidy.⁹⁶ As illustrated by Table 2 below, in every instance these reforms were estimated to increase federal tax revenues.

A general discussion of these amendments to the pension laws follows.¹¹² My main point, however, is illustrated by Table 2. The pension law "reforms" enacted by Congress during the deficit cycle were, in fact, well-disguised tax increases. The intricacies of the tax laws governing retirement plans made these tax increases virtually indiscernible, and thus invisible, to all but the most sophisticated taxpayers.¹¹³ The discussion below describes the general techniques Congress used during the deficit cycle to raise tax revenues by reducing the pension tax subsidy. These techniques reappear in Part II, where I review proposed legislation to "reform" the pension tax laws once again, this time in the context of a substantial budget surplus.

3. Deficit Cycle Reform Techniques

The most common revenue raising technique used during the deficit cycle was to reduce the maximum amounts for employer contributions and deductions for retirement plans. TEFRA lowered the annual benefit payable from a defined benefit plan to \$90,000, and lowered the annual contribution limit for participants in defined contribution plans to \$30,000.¹¹⁴ In 1987, OBRA made numerous changes to the highly technical rules for employer funding of defined benefit plans. The end result was to reduce significantly the amount of the employer's deduction for contributions to a defined benefit plan, in part by limiting deductible contributions to an amount necessary to fund the plan at 150% of current liabilities.¹¹⁵ In like fashion, the TRA of 1986 greatly restricted

96. See Salisbury, *supra* note 27, at 86. For a description of the tax treatment of private pensions prior to the enactment of ERISA, see Wooten, *supra* note 88; Dilley, *supra* note 7, at 1142-1167 (tax treatment of plans integrated for Social Security Benefits); see generally Richard L. Hubbard, *The Tax Treatment of Pensions*, in PENSION FUNDING & TAXATION, *supra* note 27, at 43-44; Salisbury, *supra* note 27, at 86-87.

112. The reader interested in a more detailed description than the one provided in this article of the legislative acts listed in Table 2 may consult Paul Yakoboski's summary contained in *Overview of the U.S. Employment-Based Retirement Income System*, EBRI-ERF Policy Forum (Dec. 1, 1999) at pages 16-18 (visited Oct. 3, 2000) <www.ebri.org>.

113. As the staff of the Joint Committee on Taxation has itself stated, "The Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex set of rules applicable to any area of the tax law." OVERVIEW OF THE PRESENT-LAW TAX RULES, *supra* note 30, at 21. My main point is further illustrated by the observations of both lawmakers and scholars that the historic reduction in personal income tax rates achieved by the Tax Reform Act of 1986 was, in fact, "paid for" in part by the equally historic elimination or decrease of many of the tax preferences previously given to pension plans and IRAs. See Goodfellow & Schieber, *supra* note 25, at 80-81; *Targeted Incentives to Increase Personal Savings: Hearing Before the Senate Comm. on Finance*, 104th Cong., 25 (1995) (Statement of Senator D'Amato).

114. TEFRA, Pub. L. No. 97-248, § 235, 96 Stat. at 505. The \$90,000 benefit payable limit for defined benefit plans was indexed for inflation; the \$30,000 limit for defined contribution plans was not. TEFRA also lowered the combined limits of Code 415(e) for participants in both defined benefit and defined contribution plans. See *id.* Congress has since repealed Code 415(e). See OVERVIEW OF PRESENT-LAW TAX RULES, *supra* note 30, at 12.

115. OBRA, Pub. L. No. 100-203, § 9301, 101 Stat. 1330-331. It is the changes made by OBRA, more than any other, that advocates for defined benefit plans point to as responsible for the decline in popularity of defined benefit plans among employers. See *Stretching the Pension Dollar*, *supra* note 40, at 3-8; Michael J.

the availability of a tax deduction for IRA contributions to persons who also participated in a qualified plan.¹¹⁶ The TRA of 1986 also reduced the maximum annual amount for elective salary deferrals under a 401(k) plan to \$7,000.¹¹⁷

A second technique used by Congress was to "cap" the amount of compensation the plan may consider in determining a participant's level of accrued benefits or pro rata share of employer contributions to the plan.¹¹⁸ The TRA of 1986 initially set a cap on compensation at \$200,000.¹¹⁹ In 1993, OBRA reduced the cap on compensation to \$150,000.¹²⁰

Gulotta, *Changing Private Pension Funding Rules and Benefit Security*, in PENSION FUNDING & TAXATION, *supra* note 27, at 119, 122. Both the *Stretching the Pension Dollar* study and Gulotta provide a complete discussion of the numerous technical changes OBRA made to the minimum funding rules for defined benefit plans.

116. TRA, Pub. L. No. 99-514, § 1101, 100 Stat. at 2416.

117. *Id.* § 1105, 100 Stat. at 2472. This \$7000 limit was indexed for inflation.

118. Defined contribution plans (other than 401(k) plans) commonly allocate employer contributions pro rata based on plan compensation because this type of plan design is a safe harbor for compliance with Code Section 401(a)(4). *See* Treas. Reg. § 1.401(a)(4)-2(b)(2) (as amended in 1993).

119. TRA, Pub. L. No. 99-514, § 1106(d), 100 Stat. at 2423. This \$200,000 compensation cap was indexed for inflation.

120. OBRA, Pub. L. No. 103-66, § 13212, 107 Stat. at 471. This \$150,000 compensation cap was indexed for inflation. *See* § 401(a)(17)(B) (1994 & Supp. IV 1998).

Table 2

THE DEFICIT CYCLE

Law	Estimated Tax Revenue Increase
TEFRA (1982) ⁹⁷	\$3,872,000,000 (1983-1987) ⁹⁸
DEFRA (1984) ⁹⁹	\$320,000,000 (1986-1989) ¹⁰⁰
TRA (1986) ¹⁰¹	\$44,442,000,000 (1987-1991) ¹⁰²
OBRA (1987) ¹⁰³	\$3,875,000,000 (1988-1990) ¹⁰⁴
TAMRA (1988) ¹⁰⁵	\$16,000,000 (1988-1990) ¹⁰⁶
UCA (1992) ¹⁰⁷	See note 107
OBRA (1993) ¹⁰⁸	\$2,383,000,000 (1994-1998) ¹⁰⁹
URAA (1994) ¹¹⁰	\$395,000,000 (1995-1999) ¹¹¹

97. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324.

98. See H.R. CONF. REP. NO. 97-760, Table 2, 693, *reprinted in* 1982 U.S.C.C.A.N. 1190, 1456.

99. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

100. H.R. REP. NO. 98-434, Part II, Table IV-2, 1101, *reprinted in* 1984 U.S.C.C.A.N. 697, 776.

101. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

102. H.R. CONF. REP. NO. 99-841, Table A.1, II-861, *reprinted in* 1986 U.S.C.C.A.N. 4075, 4949. Of this total, over half (\$23,774 million) was attributable to increased limitations on deductible IRAs. *See id.* at II-876, *reprinted in* 1986 U.S.C.C.A.N. at 4964.

103. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330.

104. H.R. REP. NO. 100-391 (II), Table 2, 1640, *reprinted in* 1987 U.S.C.C.A.N. 2313-1, 2313-1220.

105. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342.

106. *See* Joint Committee on Taxation, Comparison of the Revenue Impact of H.R. 4333, Technical Corrections Act of 1988, As Passed By the House of Representatives and As Passed By the Senate, 6 (JCX-31-88, Oct. 12, 1988).

107. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 100 Stat. 290. Although the author was unable to find in the public records numerical revenue estimates for the changes to the direct rollover rules enacted by the UCA, it is clear from the legislative history that these amendments were part of the "financing provisions" necessary to pay for the primary purpose of the bill—to extend unemployment compensation benefits. *See* H.R. CONF. REP. NO. 102-650, 41-44, *reprinted in* 1992 U.S.C.C.A.N. 255, 265-268 (listing changes to the direct rollover rules under the "Financing Provisions").

108. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312.

109. H.R. REP. NO. 103-111, 813, *reprinted in* 1993 U.S.C.C.A.N. 378, 1043.

110. Uruguay Round Agreements Act of 1994, Pub. L. No. 103-465, 108 Stat. 4809.

111. H.R. REP. NO. 103-826 (I), 236, *reprinted in* 1994 U.S.C.C.A.N. 3773, 4008.

Table 3 below illustrates the consequences of imposing a cap on compensation for purposes of allocating an employer's contribution to a profit sharing plan. The table assumes the plan allocates a \$50,000 employer contribution to the plan pro rata to plan participants based on their compensation.

Table 3

COMPENSATION CAP EFFECTS

Employee	Actual Compensation	Allocation Pre-OBRA	Allocation Post-OBRA ¹²¹
1	\$225,000	\$28,125	\$23,077
2	\$75,000	\$9,375	\$11,538
3	\$40,000	\$5,000	\$6,154
4	\$35,000	\$4,375	\$5,385
5	\$25,000	\$3,125	\$3,846
Total	\$400,000	\$50,000	\$50,000

Table 3 illustrates the two effects of imposing a cap on participant compensation in the context of a profit sharing plan. The *revenue effect* is to reduce the tax-favored plan benefits for higher income tax bracket participants with earnings above the cap.¹²² The *distributional effect* is to increase the amount of plan benefits to participants who earn less than the cap amount.¹²³

A third technique involved the creation of a special nondiscrimination rule for 401(k) plans.¹²⁴ This special rule, known as the actual deferral percentage (ADP) test,¹²⁵ limits the amount of elective salary deferrals for highly compensated employees by "linking" the level of their salary deferrals to the levels achieved by non-highly compensated employees under the plan.¹²⁶ Application of these special nondiscrimination rules

121. Although Employee 1 has actual compensation of \$225,000, for purposes of allocating employer contributions, his compensation is capped at \$150,000. As a result, Employee 1's pro rata share of the \$50,000 employer contribution is reduced from 56.25% (\$225,000/\$400,000) to 46.15% (\$150,000/\$325,000). The pro rata shares of Employees 2-5 are correspondingly increased.

122. See Bankman, *supra* note 93, 55 U. CHI. L. REV. at 835 (advocating for direct limitations on pension-related tax benefits to highly compensated employees); Fiona E. Liston & Adrien R. LaBombarde, *Decreasing the Compensation Cap for Pensions: Consequences for National Retirement Policy*, in PENSION FUNDING & TAXATION, *supra* note 27, at 131, 132-133 (describing with examples the decrease in benefits or contributions for participants whose compensation exceeds the \$150,000 cap).

123. See H.R. REP. NO. 103-111, 650 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 881 (justifying OBRA '93's reduction of the compensation amount as strengthening the nondiscrimination rules).

124. See DEFRA, Pub. L. No. 98-369, § 527, 98 Stat. at 875; TRA, Pub. L. No. 99-514, §§ 1116-1117, 100 Stat. at 2454-63.

125. See I.R.C. § 401(k)(3)(A)(ii) (1994 & Supp. IV 1998); Treas. Reg. § 1.401(k)-1(b)(2) (as amended in 1991).

126. The ADP test limits elective salary deferrals (determined as a percentage of compensation) for highly compensated employees to a multiple of the corresponding deferrals (again determined as a percentage of compensation) for non-highly compensated employees. See *Overview of Present-Law Tax Rules*, *supra* note

generally reduces the amount highly compensated employees can defer in salary to a 401(k) plan to well below the legally allowable maximum amount.¹²⁷

The remaining group of revenue-raising techniques used by Congress during the deficit cycle might be characterized as the "nickel and dime" approach to pension tax law reform. Excise tax penalties were created for premature plan distributions¹²⁸ and for an asset reversion to an employer caused by the termination of an over-funded defined benefit plan.¹²⁹ The maximum amount of a non-taxable plan loan was limited to \$50,000.¹³⁰ Annual cost of living adjustments for contribution and deduction limits that had been indexed for inflation were frozen,¹³¹ or the timing of cost of living adjustments was delayed.¹³² Finally, plan administrators were required to withhold for income taxes a fixed 20% of any qualified plan distribution to a participant that could have been, but was not, directly "rolled over" to another eligible qualified plan or an IRA ("the direct rollover rules").¹³³

One more set of rules must be described to complete this historical overview of pension "reform" legislation enacted during the deficit cycle. In TEFRA and DEFRA, Congress created the *top-heavy rules*.¹³⁴ Both the top-heavy rules and the nondiscrimination rules are concerned with the more equitable distribution of plan benefits to rank-and-file employees. Unfortunately, these two sets of rules use different definitions ("key employee" versus "highly compensated employee") for purposes of numerical testing, making the top-heavy rules a prime target for pension "simplification" during the surplus cycle.¹³⁵

Toward the end of the deficit cycle, it was beginning to become apparent that many workers, particularly those in the "baby-boomer" generation, were ill-prepared financially for retirement.¹³⁶ Although lawmakers in Congress clearly were concerned that

30, at 9; see generally FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS, *supra* note 93, CHAP. 8, 96-97 (describing the ADP test).

127. See FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS, *supra* note 93, Table 8.1 at 98. When combined with the cap on compensation, the usual result is to further reduce the amount highly compensated employees can defer in salary for the 401(k) plan. See Liston & LaBombarde, *supra* note 122, at 133-34.

128. See TRA, Pub. L. No. 99-514, § 1123, 100 Stat. at 2472.

129. See TAMRA, Pub. L. No. 100-647, § 6069, 102 Stat. at 3704; Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 12002, 104 Stat. 1388-1, 1388-562 (increasing the employer's excise tax on asset reversions from terminated plans to 50%).

130. See TRA, Pub. L. No. 99-514, § 1134, 100 Stat. at 2483.

131. See DEPRA, Pub. L. No. 98-369, § 15, 98 Stat. at 505.

132. See Uruguay Round Agreements Act, Pub. L. No. 103-465, § 732, 108 Stat. 4809, 5004.

133. See Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, § 521, 106 Stat. 290, 300.

134. See TEFRA, Pub. L. No. 97-248, § 240, 96 Stat. 514; DEFRA, Pub. L. No. 98-368, § 524, 98 Stat. 872 (codified at I.R.C. § 416 (1994 & Supp. IV 1998)). The purposes of the top-heavy rules are to allocate more plan benefits to "non-key" employees and to vest these benefits more quickly in plans that are "top-heavy" with benefits for "key" employees. See I.R.C. § 416 (1994 & Supp. IV 1998). See generally U.S. GEN. ACCOUNTING OFFICE, PRIVATE PENSIONS: "TOP-HEAVY RULES FOR OWNER-DOMINATED PLANS G-20 (2000).

135. Compare I.R.C. § 416(i)(1) (1994 & Supp. IV 1998) (definition of key employees) with I.R.C. § 414(q) (1994 & Supp. IV 1998) (definition of highly-compensated employees).

136. See generally Hearing On Defusing the Retirement Time Bomb: Encouraging Pension Savings Before the Subcommittee on Employer-Employee Relations of the House of Representatives Committee on Education and the Workforce, 105th Cong. (1997); Targeted Incentives to Increase Personal Savings: Hearing Before the Senate Committee on Finance, 104th Cong. (1995); IRAs, 401(k) Plans, and Other Savings Proposals: Hearing Before the Senate Committee on Finance, 104th Cong. (1995); U.S. Private Savings Crisis--Long-

workers lacked employer-sponsored pension coverage and were not saving for retirement on their own, concern over the budget deficit limited their ability to pass legislation addressing these problems.¹³⁷ This attitude changed dramatically once it became apparent to lawmakers that budget surpluses would soon replace budget deficits.

4. *The Pension Law Surplus Cycle: 1996 - Present*

Legislative efforts to reduce the budget deficit, aided by sustained economic growth, proved successful. Congress responded by reversing course in pension tax policy. Instead of legislation designed to raise tax revenues by reducing the pension tax expendi-

Term Economic Implications and Options for Reform: Hearing Before the Subcommittee on Deficits, Debt Management and Long-Term Economic Growth of the Senate Committee on Finance, 103rd Cong. (1994); Retirement Income Security: Can the Baby Boom Generation Afford to Retire: Hearing Before the Subcommittee on Social Security of the House of Representatives Committee on Ways and Means, 103d Cong. (1993).

Congressman Harris F. Fawell described the problem as follows:

It does not take a mathematician to recognize that in the future retiring Americans will have to rely less on social security and more on pension and personal savings. With the coming retirement of baby boomers, we face a demographic time bomb that is going to explode and hurt a lot of people if we do not begin defusing it now. Make no mistake, we have all known of this problem for a long time. Sixteen years ago this month President Carter's Commission on Pension Policy reported that a "serious crisis" existed in our retirement income programs, and that baby boomers will place "severe strains" on an "already overburdened system." It's 16 years later and the problems have only gotten bigger as they have come closer.

To defuse the retirement time bomb, we must increase accessibility--by giving Americans easier access to pensions and the ability to save for retirement. We must increase security--by making sure retirement nest eggs are as well protected under the Federal pension law, ERISA, as possible to ensure a solid system where money can grow. And we must increase information--by making sure American workers have an understanding of the need for, and the steps to achieve, retirement savings they can count on in their golden years.

Hearing on Defusing the Retirement Time Bomb, *supra*, at 4.

137. The following exchange illustrates the point.

[Congressman Harris F. Fawell, Chairman:] I think all of us would agree that OBRA 87 was perhaps a tragic mistake but maybe something we can't change right now because of revenue problems. It certainly has a deep detrimental effect upon defined benefit plans, I gather, because employers were just proscribed from being able to adequately, I gather, fund... So, apparently it had a terrible effect, because we were trying to save revenue so we could balance the budget, which we never did anyway. But we always use that as being good pension law... So I guess that would be something that I would be--I guess most everybody would say that was a mistake. . . . I will start with [you], Mr. [Sylvester J.] Schieber. If you had your druthers, which law would you say this is what we should at least immediately do?

Mr. Schieber: If you are going to start with the premise that we could not afford to reverse OBRA 87, for example, you are saying that you have absolutely no resources at the Federal level to address this larger national savings issue----

Chairman Fawell: We are not an appropriations committee, as I say.

Mr. Schieber: Well, you may be out running this race with both of your hands tied behind your back and your shoe laces tied together to boot. . . .

Hearing on Defusing the Retirement Time Bomb, *supra* note 136, 144-45.

ture, Congress began enacting legislation that increased the tax expenditure for qualified plans and IRAs.

The Small Business Job Protection Act of 1996¹³⁸ ("SBJPA") represented a significant change in Congress's approach to national retirement policy. One common theme underlying the SBJPA was simplification of the complex rules governing the administration of qualified plans.¹³⁹ The purpose of these simplification amendments was to encourage more employers to sponsor retirement plans by reducing the administrative burden associated with plan sponsorship.¹⁴⁰

The SBJPA also marked Congress's first attempt to expand the scope of pension coverage by creating special incentives for employers having 100 or fewer employees.¹⁴¹ This was done by creating a different set of rules based solely on employer size--the creation of so-called "SIMPLE plans."¹⁴² SIMPLE plans represent a new approach to pension law policy. Historically, the Code Section 401(a) requirements for qualified plans have applied to all employers, irrespective of employer size.¹⁴³ SIMPLE plans were the first deviation from what previously had been a uniform set of qualified plan design rules for employers of all sizes.¹⁴⁴

The Taxpayer Relief Act of 1997 ("TRA97") followed the SBJPA.¹⁴⁵ TRA97 marked another significant change in Congress's approach to national retirement policy. A renewed emphasis was placed on tax incentives designed to encourage individuals to save

138. Pub. L. No. 104-188, 110 Stat. 1755 (codified as amended in scattered sections of 26 U.S.C.).

139. The Small Business Job Protection Act of 1996 repealed the family aggregation rules, changed the definition of compensation for purposes of applying the Code Section 415 limits, changed the definition of a leased employee, simplified the definition of a highly compensated employee, repealed the combined plan limits of Code Section 415(e), allowed for waivers of the 30-day waiting period for plan distributions, simplified the minimum participation rules, and created a "safe harbor" for 401(k) plan nondiscrimination testing. See Pub. L. No. 104-188, §§ 1431-34, 1451-52, 1454. Excepting the repeal of Code Section 415(e) and the safe harbor for 401(k) plan nondiscrimination testing, these simplifying changes had a negligible revenue effect. See H.R. CONF. REP. NO. 104-737, at 361-368 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1853-60. The SBJPA did make one change that significantly reduced the pension tax expenditure. The repeal of 5-year averaging for income taxation of lump sum distributions increased tax revenues from 1996-2000 by an estimated \$337 million. See Pub. L. No. 104-188, § 1401, H.R. CONF. REP. NO. 104-737 at 364 (1996), *reprinted in* 1996 U.S.C.C.A.N. at 1856.

140. See H.R. CONF. REP. NO. 104-737, at 240-74 (1996), *reprinted in* 1996 U.S.C.C.A.N. at 1732-66; S. REP. NO. 104-281, at 73-98 (1996); *reprinted in* 1996 U.S.C.C.A.N. at 1547-72.

141. Pub. L. No. 104-188, § 1422, 110 Stat. 1800-01.

142. SIMPLE plans essentially are 401(k) plans with a required employer matching contribution. A SIMPLE plan may be adopted by an employer having no more than 100 employees who does not sponsor another retirement plan. SIMPLE plans are exempt from the special nondiscrimination rules for 401(k) plans. See *supra* note 77 and accompanying text. This exemption ensures that highly compensated employees can defer the maximum annual amount of \$6,000 for the SIMPLE plan, regardless of the level of salary deferrals made by the non-highly compensated employees. The merits of SIMPLE plans are analyzed in detail in Richard J. Kovach, *A Critique of SIMPLE--Yet Another Tax-Favored Retirement Plan*, 32 NEW ENG. L. REV. 401 (1998).

The tax subsidy for 1996-2000 for SIMPLE plans was estimated at \$286 million. See H.R. CONF. REP. NO. 104-737, at 364 (1996), *reprinted in* 1996 U.S.C.C.A.N. at 1856.

143. See I.R.C. § 401(a) (1994 & Supp. IV 1998).

144. Prior to the enactment of SIMPLE plans, the multiple sets of rules governing qualified plans differentiated among employers by type of business (private sector for profit, tax exempt organizations, educational institutions and governmental entities and agencies) or by type of plan (defined benefit, defined contribution, 401(k) plan, or employee stock ownership plan, to name a few). See FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS, *supra* note 93, at CHAP. 4, 6-10, 15, 39-40.

145. Pub. L. No. 105-134, 111 Stat. 788 (codified as amended in scattered sections of 26 U.S.C.).

for their own retirement. The SBJPA had moved in this policy direction by increasing the availability of deductible IRAs for non-working spouses.¹⁴⁶ To further encourage private retirement savings, Congress increased the income limits for deductible IRAs.¹⁴⁷ It also created a new type of retirement savings vehicle, the "Roth" IRA, with substantially higher income limits than the traditional IRA.¹⁴⁸

These three trends, administrative simplification, special incentives based solely on employer size, and increased incentives for individual retirement savings, continue as strong themes underlying proposed legislation to reform the pension tax law system. Part II examines these proposals to determine whether they are likely to advance the goal of national retirement policy.

III. POLICY APPROACHES AND CHOICES IN PROPOSALS FOR REFORM

A. Common Themes in Proposed Legislation

During the last two years lawmakers in Congress have introduced numerous legislative bills proposing reforms to the pension tax law system.¹⁴⁹ A review of proposed legislation reveals four common themes for change in the pension tax laws. First and foremost, almost all of the proposals would increase the maximum amounts under the limitations rules for qualified retirement plans and IRAs. Second, some proposals would expand the SIMPLE plan approach and create another set of special rules for defined benefit plans sponsored by smaller employers. A third set of proposals offer tax credits and other incentives for employers to sponsor retirement plans. Finally, many of the

146. Pub. L. No. 104-188, § 1427. The estimated tax subsidy resulting from this provision for 1996-2000 was \$604 million. See H.R. CONF. REP. NO. 104-737, at 364 (1996), *reprinted in* 1996 U.S.C.C.A.N. at 1856.

147. Pub. L. No. 105-34, § 301, 111 Stat. at 824-25.

148. *Id.* § 302. The differing tax treatment of deductible and Roth IRAs is discussed *supra* notes 80-82 and accompanying text. The estimated tax subsidy resulting from the changes to deductible IRAs and the creation of the Roth IRA for 1997-2002 was \$1.832 billion. See H.R. CONF. REP. NO. 105-220, at 779 (1997), *reprinted in* 1997 U.S.C.C.A.N. at 1590.

149. Comprehensive Retirement Security and Pension Reform Act, H.R. 1102, 106th Cong. (1999) (since renumbered as H.R. 4843 as part of a House Ways and Means Committee amendment); Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. (1999); Wage and Employment Growth Act of 1999, H.R. 3081, 106th Cong. (1999); Retirement Savings Opportunity Act of 1999, H.R. 1546, 106th Cong. (1999); Income Security Enhancement Act of 1999, S. 8, 106th Cong. (1999); Pension Coverage and Portability Act, S. 741, 106th Cong. (1999); Retirement Savings Opportunity Act of 1999, S. 649, 106th Cong. (1999); Taxpayer Refund Act of 1999, S. 1429, 106th Cong. (1999); H.R. 2082, 106th Cong. (1999); Enhanced Savings Opportunity Act, S. 60, 106th Cong. (1999); Secure Assets for Employees (SAFE) Plan Act of 1999, H.R. 2190, 106th Cong. (1999); Employee Pension Portability and Accountability Act of 1999, H.R. 1213, 106th Cong. (1999); Retirement Account Portability Act of 1999, H.R. 739, 106th Cong. (1999); Retirement Savings Opportunity Act of 1999, S. 646, 106th Cong. (1999); Women's Pension Prevention Act of 1999, S. 132, 106th Cong. (1999); Retirement Account Portability Act of 1999, S. 1357, 106th Cong. (1999); Retirement Security Act of 1999, H.R. 1590, 106th Cong. (1999); S. 1209, 106th Cong. (1999); Pension Opportunities for Women's Equality In Retirement Act, S. 2671, 106th Cong. (2000). H.R. 2488 was passed by both houses of Congress. President Clinton vetoed the enrolled bill on September 23, 1999. As of the time this article went to press, H.R. 1102, *supra*, had been passed by the House and was awaiting action in the Senate. President Clinton is on record as strongly opposing H.R. 1102, making a veto likely if the Senate passed the bill. See *Statement of Administration Policy on H.R. 1102* (July 19, 2000) (visited Oct. 3, 2000) <<http://www.whitehouse.gov>>.

proposals would simplify the rules governing retirement plan administration. Each of these common themes is described below.

1. Increasing Contributions and Benefits Limits

Proposals to increase the maximum amounts under the limitations rules essentially would reverse the lower limits enacted during the deficit cycle. Table 4 below summarizes the proposed increases for the limitations rules.

Other proposed reforms, however, go beyond merely restoring the limitation amounts of the pre-1982 status quo. There are several proposed reforms that would significantly change the way these limitations rules traditionally have functioned. The likely result, if these reform proposals are enacted, will be a significant increase in the pension tax subsidy.

Table 4

Proposals to Change the Limitations Rules

Limitation Rule	Current Limit¹⁵⁰	Proposed Limit	Estimated Revenue Loss (millions) (2000-09)
maximum annual benefit from a defined benefit plan	\$135,000	\$160,000 ¹⁵¹	396 ¹⁵²
maximum contribution per participant from defined contribution plans	\$30,000	\$40,000 ¹⁵³	125 ¹⁵⁴

150. The current limits in this column are for the year 2000. See *IRS News Release (IR-1999-80) on Pension Plan Limitations for Tax Year 2000*, Daily Tax Rep. (BNA) L-2 (Oct. 20, 1999).

151. H.R. 2488, 106th Cong. § 1201; H.R. 3081, 106th Cong. § 301; S. 2671, 106th Cong. § 101. Other proposals would increase this limit to \$180,000. See H.R. 1102, 106th Cong. § 101; H.R. 2082, 106th Cong. § 2; S. 1209, 106th Cong. § 2.

152. Joint Committee on Taxation Summary and Revenue Estimates on Conference Agreement on H.R. 2488, Taxpayer Refund and Relief Act of 1999, JCX-61-99R (Aug. 5, 1999).

153. H.R. 2488, 106th Cong. § 1201; H.R. 3081, 106th Cong. § 301; H.R. 1546, 106th Cong. § 204; S. 2671, *I.* § 101. Other proposals would increase the maximum contribution limit to \$45,000 and, in addition, increase the 15% of compensation deduction limit for profit sharing and stock bonus plans, see I.R.C. § 404 (West 1999), to 25% of compensation. See H.R. 1102, 106th Cong. §§ 101, 111.

Proposed legislation also would allow participants to contribute the lesser of 100% of their compensation or the maximum allowable dollar amount. See H.R. 1546, 106th Cong. § 204; H.R. 1102, 106th Cong. § 202; S. 741, 106th Cong. § 201; S. 649, 106th Cong. § 204; H.R. 2082, 106th Cong. § 2; S. 1209, 106th Cong. § 2; S. 60, 106th Cong. § 2; S. 646, 106th Cong. § 204.

154. Summary and Revenue Estimates on H.R. 2488, *supra* note 152, at 9.

Limitation Rule	Current Limit ¹⁵⁰	Proposed Limit	Estimated Revenue Loss (millions) (2000-09)
maximum elective deferrals--401(k) plans	\$10,500	\$15,000 ¹⁵⁵	5,168 ¹⁵⁶
maximum elective deferrals- SIMPLE plans	\$6,000	\$10,000 ¹⁵⁷	220 ¹⁵⁸
cap on c compensation for contribution / benefit calculations	\$170,000	\$200,000 ¹⁵⁹	776 ¹⁶⁰

155. See H.R. 2488, 106th Cong. § 1201; H.R. 3081, 106th Cong. § 301; H.R. 1546, 106th Cong. § 202; H.R. 1102, 106th Cong. § 101; S. 649, 106th Cong. § 202; S. 646, 106th Cong. § 202. Other proposals would increase the salary deferral limit to \$12,000. See S. 741, 106th Cong. § 402. Still others would phase in the higher \$15,000 limit over a period of years. See S. 2671, 106th Cong. § 101.

156. Summary and Revenue Estimates on H.R. 2488, *supra* note 152, at 8.

157. H.R. 2488, 106th Cong. § 1201; H.R. 3081, 106th Cong. § 301; H.R. 1546, 106th Cong. § 303; H.R. 1102, 106th Cong. § 101; S. 649, 106th Cong. § 303; S. 646, 106th Cong. § 303. Other proposals would increase SIMPLE plan salary deferrals to \$8,000. See S. 741, 106th Cong. § 107. Alternative proposals would phase in the higher \$10,000 limit over a period of years, see S. 2671, 106th Cong. § 101.

158. Summary and Revenue Estimates on H.R. 2488, *supra* note 152, at 8.

159. H.R. 2488, 106th Cong. § 1201; H.R. 3081, 106th Cong. § 301; S. 741, 106th Cong. § 402; S. 2671, 106th Cong. § 101. Other proposals would increase the compensation cap to \$235,000. See H.R. 1102, 106th Cong. § 101.

160. Summary and Revenue Estimates on H.R. 2488, *supra* note 152, at 9.

Table 4 continued

Limitation Rule	Current Limit ¹⁵⁰	Proposed Limit	Estimated Revenue Loss (millions) (2000-09)
full funding limit for defined benefit plan	155-170% of current liabilities ¹⁶¹	% Limit repealed by 2004; other deduction limits modified ¹⁶²	290 ¹⁶³
contribution limit for deductible and Roth IRAs	\$2,000	Increase to \$5,000 by 2008; indexed for inflation thereafter ¹⁶⁴	27,429 ¹⁶⁵

The \$30,000 maximum contribution limit per participant for employer contributions to defined contribution plans traditionally has *included* elective salary deferrals.¹⁶⁶ Lawmakers have proposed to change this rule and *exclude* elective salary deferrals from the maximum contribution limit.¹⁶⁷ Example 4 below illustrates the effect of this proposal when combined with other proposed increases under the limitations rules.

Example 4

In 2000, Employee makes a \$10,500 salary deferral contribution to her employer's 401(k) plan. Because this contribution is counted toward the overall maximum limit of \$30,000 for defined contribution plans, the most that the employer can contribute for Employee to defined contribution plans is \$19,500. Employee's actual compensation is over \$210,000, but for purposes of the pension tax laws her compensation is capped at \$170,000. To contribute the maximum amount of \$19,500 for Employee, the employer

150. The current limits in this column are for the year 2000. See *IRS News Release (IR-1999-80) on Pension Plan Limitations for Tax Year 2000*, Daily Tax Rep. (BNA) L-2 (Oct. 20, 1999).

161. I.R.C. § 412(c)(7)(F) (Supp. IV 1998). Under current law the full funding limit is gradually increased from 155% of current liabilities in 1999-2000 to 170% of current liabilities in 2005 and succeeding years.

162. H.R. 2488, 106th Cong. §§ 1241-1242; H.R. 3081, 106th Cong. §§ 341-342; H.R. 1546, 106th Cong. § 205; S. 8, 106th Cong. § 429; H.R. 1102, 106th Cong. § 401; S. 741, 106th Cong. § 401; S. 649, 106th Cong. § 205; H.R. 1590, 106th Cong. § 129; S. 646, 106th Cong. § 205.

163. Summary and Revenue Estimates on H.R. 2488, *supra* note 152, at 10.

164. See H.R. 2488, 106th Cong. § 211. Other proposals would immediately increase the contribution limit to \$5,000, see H.R. 1546, 106th Cong. § 101; H.R. 1102, 106th Cong. § 101; S. 649, 106th Cong. § 101; S. 646, 106th Cong. § 101.

165. Summary and Revenue Estimates on H.R. 2488, *supra* note 152, at 2.

166. I.R.C. § 415(c) (1994 & Supp. IV 1998). Elective salary deferrals must be made to a plan established under Code Sections 401(k), 403(b) or 457.

167. H.R. 2488, 106th Cong. § 1204; H.R. 3081, 106th Cong. § 304; H.R. 1546, 106th Cong. § 204(c); H.R. 1102, 106th Cong. § 105; S. 741, 106th Cong. § 112; S. 60, 106th Cong. § 2; S. 646, 106th Cong. § 204.

must make a contribution equal to approximately 11.4% of her capped compensation. The total amount that Employee has increased her retirement savings in qualified plans for the year is \$30,000.

In 2005, under the new pension tax laws Employee makes a \$15,000 salary deferral contribution to her employer's 401(k) plan. This contribution is no longer counted toward the increased overall maximum contribution limit of \$40,000 for defined contribution plans. By 2005, the Employee's compensation cap has increased to \$210,000 (\$200,000 indexed for inflation). The employer makes a contribution for Employee to defined contribution plans equal to 19% of her capped compensation of \$210,000 (\$40,000). The total amount that Employee increases her retirement savings in qualified plans for the year is \$55,000—an 83% increase from 2000.

The Joint Committee on Taxation estimates a revenue loss for this provision of \$759 million from 2000 through 2009.¹⁶⁸ Lawmakers also have proposed increased limits rules for elective salary deferrals and IRAs for individuals who are age 50 or older.¹⁶⁹ These additional amounts are known as "catch-up" contributions because their purpose is to allow an individual who is approaching retirement to make up for failing to save adequately in younger years.¹⁷⁰ Example 5 below illustrates the effect of enacting proposed "catch-up" contributions when combined with other proposed changes to the limitations rules.

Example 5

Assume that in 2005 Employee is age 50. She defers \$15,000 in salary to her employer's 401(k) plan. Under the new pension tax laws she also makes an additional "catch up" contribution to her 401(k) plan of \$7,500 (50% of her regular 401(k) salary deferral amount). Her total 401(k) plan contributions for the year are \$22,500—a 125% increase from 2000.

The employer also makes a contribution for Employee to defined contribution plans equal to 19% of her capped compensation of \$210,000 (\$40,000). Employee has increased her retirement savings in qualified plans for the year by \$62,500, a 108% increase from 2000.

The Joint Committee on Taxation estimates a revenue loss for catch-up provisions for elective salary deferrals of \$825 million and for IRAs of \$3,694 million from 2000 to 2009.¹⁷¹

In my examples above, the hypothetical employee is a highly-compensated employee with earnings above the compensation cap. Example 5 assumes that the 401(k) plan is a safe harbor plan with employer matching contributions. Such a safe harbor is exempt from ADP testing, thereby allowing all of the highly compensated employees to

¹⁶⁸ Joint Committee on Taxation Summary and Revenue Estimates on Conference Agreement on H.R. 2488, Taxpayer Refund and Relief Act of 1999, JCX-61-99R (Aug. 5, 1999).

¹⁶⁹ H.R. 2488, 106th Cong. §§ 214, 1221; H.R. 3081, 106th Cong. § 321; H.R. 1546, 106th Cong. § 401; H.R. 1102, 106th Cong. § 201; S. 649, 106th Cong. § 401; S. 646, 106th Cong. § 401; S. 2671, 106th Cong. § 201.

¹⁷⁰ See generally Kovach, *supra* note 142, at 422.

¹⁷¹ Summary and Revenue Estimates on H.R. 2488, *supra* note 152, at 3, 9.

defer the maximum amount to the 401(k) plan.¹⁷² If the employer's 401(k) plan does not qualify for the ADP testing exemption, the amount of the hypothetical employee's maximum salary deferral is likely to be substantially less due to the additional limits of the ADP test on salary deferrals of highly-compensated employees.¹⁷³

Under current law, if my hypothetical employee deferred more in salary than was permitted under the ADP test, one correction method is to distribute the "excess" contribution amount to the highly-compensated employee.¹⁷⁴ Proposed legislation would change this rule so that excess contributions of highly-compensated employees to 401(k) plans are treated similarly to after-tax contributions to Roth IRAs.¹⁷⁵ The employee's excess contribution amount (called a "qualified plus contribution") would be treated as an after-tax contribution to the plan. The qualified plus contribution amount stays inside the 401(k) plan until withdrawn. Investment earnings on excess contribution amounts, like investment earnings for Roth IRAs, would not be taxed when earned or withdrawn.¹⁷⁶ Although my hypothetical employee loses the benefit of an immediate income tax savings for the qualified plus contribution, she gains the longer term benefit of tax-free investment earnings. The estimated revenue loss from this provision is \$155 million from 2000 to 2009.¹⁷⁷ The real revenue loss, of course, would likely not be seen until after 2009, when accumulated investment earnings on qualified plus contributions are withdrawn by the numerous employees free of federal income tax.

2. SAFE (or SMART) Defined Benefit Plans for Smaller Employers

Lawmakers have proposed to build upon the SIMPLE plan's approach to reform by creating a separate set of rules for defined benefit plans sponsored by smaller employers.¹⁷⁸ The proposal for these SAFE (or SMART) defined benefit plans is based on a model advocated by the American Society of Pension Actuaries.¹⁷⁹ Defined benefit retirement plans are uncommon among smaller employers.¹⁸⁰ Proponents of SAFE plans contend that creating a less complex set of administrative rules for smaller employers will encourage them to sponsor defined benefit plans for their workers.¹⁸¹ Proponents also argue that making SAFE plans available for smaller employers is particularly important because "small business employees who are baby boomers and who have not

172. See I.R.C. § 401(k)(12) (Supp. IV 1998).

173. See *supra* note 77 and accompanying text.

174. See Treas. Reg. § 1.401(k)-1(f) (as amended in 1994). The employee is subject to income tax on this distribution of excess contributions.

175. See H.R. 2488, 106th Cong. § 1208; H.R. 3081, 106th Cong. § 308; H.R. 1546, 106th Cong. § 201; H.R. 1102, 106th Cong. § 112; S. 649, 106th Cong. § 201; S. 646, 106th Cong. § 201; S. 2671, 106th Cong. § 104.

176. See Summary of the Revenue Provisions of the Conference Agreement on H.R. 2488, The "Taxpayer Refund and Relief Act of 1999," 21, Joint Comm. on Taxation, JCX-66-99 (Aug. 6, 1999).

177. Summary of Revenue Estimates on H.R. 2488, *supra* note 152, at 9.

178. See H.R. 2190, 106th Cong. § 2; H.R. 1546, 106th Cong. § 302; S. 8, 106th Cong. § 415; S. 741, 106th Cong. § 103; S. 649, 106th Cong. § 302; H.R. 1590, 106th Cong. § 111; H.R. 2190, 106th Cong. § 2; H.R. 1213, 106th Cong. § 4; S. 646, 106th Cong. § 302.

179. See Pensions: Simplified Defined Benefit Plan Bill Introduced In House by Pension Leaders, 96 DAILY TAX REP. (BNA), G-4 (May 19, 1997) [Pensions].

180. See SMALL ESTABLISHMENTS, *supra* note 11, Table 1 at 5 (only 15% of all employees of smaller employers participate in defined benefit plans).

181. See Pensions, *supra* note 179.

previously been covered under retirement plans will not be able to save enough under the newly enacted SIMPLE or a Section 401(k) plan to provide an adequate retirement income."¹⁸²

The eligibility requirements for the SAFE plan are the same as for the SIMPLE plan. SAFE plans would be available only to smaller employers who do not sponsor another qualified plan (other than a SIMPLE or 401(k) plan).¹⁸³ The employer would elect a SAFE plan benefit for participants of either one, two, or three percent of compensation for each year of service.¹⁸⁴ Each participant would be immediately and fully vested in his SAFE plan benefits.¹⁸⁵ The SAFE plan benefits would be fully funded on an actuarial basis at all times.¹⁸⁶ Example 6 below illustrates the retirement benefit available to a participant in a SAFE plan.

Example 6

In 2000, Employer establishes a SAFE plan, electing to provide a benefit to each employer equal to three percent of compensation for each year of service. In 2025, Employee retires after 25 years of service with an average salary of \$40,000. Employee will receive a minimum annual pension benefit of \$30,000.¹⁸⁷

3. Tax Credits and Other Financial Incentives for New Plan Sponsorship

In addition to SAFE plans, proposed legislation contains a variety of other financial incentives designed to encourage smaller employers to sponsor retirement plans. A close review of these financial incentives indicates that these incentives will have a minimal impact on the size of the pension tax expenditure.

One proposed incentive is a tax credit for the administrative costs of sponsoring a new retirement plan.¹⁸⁸ The employer's tax credit for the costs associated with establishing a new retirement plan is limited to 50% of these costs, subject to a maximum limit varying from \$2,000 to \$500 for the first year and \$500 for each of the following two years.¹⁸⁹ Only smaller employers who do not maintain another qualified plan (other than a SIMPLE or SAFE plan) would be eligible for this tax credit.¹⁹⁰ The tax credit is particularly generous for the sole owner of an employer treated as a conduit entity for tax purposes.¹⁹¹ For a plan with an initial start-up cost of \$2000, the combined effect of the tax credit with the owner's business deduction for plan sponsorship costs would mean

182. See Pensions, *supra* note 179 (Statement of Brian Graff, Executive Director of the American Society of Pension Actuaries).

183. See H.R. 2190, 106th Cong. § 2(a).

184. See *id.*

185. See *id.*

186. See *id.*

187. See Pensions, *supra* note 179.

188. See H.R. 1590, 106th Cong. § 101 (1999); H.R. 1546, 106th Cong. § 301 (1999); S. 8, 106th Cong. § 411 (1999); H.R. 1102, 106th Cong. § 113 (1999); S. 741, 106th Cong. § 106 (1999); S. 649, 106th Cong. § 301 (1999); H.R. 1213 106th Cong. § 3 (1999); S. 646, 106th Cong. § 301 (1999).

189. See *id.*

190. See *id.*

191. See discussion *infra* Part III.B.2.

that the owner would incur no costs to establish the new retirement plan.¹⁹²

Other financial incentives to reduce the costs of plan sponsorship are minimal in amount. For example, waiving the user fee for submitting a newly established plan to the Internal Revenue Service for a review of compliance with the Code 401(a) regulations¹⁹³ will likely save the employer only \$125 to \$700.¹⁹⁴ Like the proposed SAFE plan and the tax credit for new plans, this proposed incentive would be available only to smaller employers.¹⁹⁵

Another type of financial incentive is directed at owners of employers who are organized as S corporations, partnerships, or sole proprietorships. Under the current pension tax laws, owners of these types of employers are prohibited from receiving loans from the employer's retirement plan.¹⁹⁶ Proposed legislation would repeal this prohibition,¹⁹⁷ with a resulting estimated revenue loss of \$325 million for 2000 to 2009.¹⁹⁸ The underlying assumption, of course, is that the owner-employee will be more willing to sponsor a qualified plan if he has the ability to benefit by personally taking out a loan from the plan.

4. Administrative Simplification

The Small Business Jobs Protection Act made numerous changes aimed at simplifying the administration of qualified plans.¹⁹⁹ Many of the current proposals continue this trend, targeting the complex rules for direct rollovers,²⁰⁰ the required minimum distribution rules,²⁰¹ annual valuations for defined benefit plans,²⁰² annual form 5500 reporting,²⁰³ and the IRS-administered system of programs to correct compliance fail-

192. For example, assume that the employer is organized as an S corporation having only one shareholder, O. If O is in a 50% marginal income tax bracket (combined state and federal), a deduction of \$2,000 incurred to establish the new plan results in a personal income tax savings of \$1,000. When the effect of the deduction is added to the tax credit of \$1,000, O has saved a total of \$2,000 in taxes for establishing the plan, which negates the corporation's start-up costs of \$2,000.

193. See H.R. 2488, 106th Cong. § 1206 (1999); H.R. 3081, 106th Cong. § 306 (1999); H.R. 1102, 106th Cong. § 109; S. 741, 106th Cong. § 110.

194. For an individualized plan applying the ratio percentage coverage test submitted for determination on Form 5300, the user fee is \$700. For a prototype or volume submitter plan applying the ratio percentage coverage test submitted for determination on Form 5307, the user fee is \$125. See Internal Revenue Service Form 8717, *User Fee for Employer Plan Determination Letter Request* (Rev. Feb. 2000). If the employer's plan applies the average benefit coverage test, the user fee is \$1,000 to \$1,250. See *id.* The estimated loss of revenue for this provision from 2000 to 2009 is \$52 million. See *Summary and Revenue Estimates on H.R. 2488*, *supra* note 152, at 9.

195. See H.R. 2488, 106th Cong. § 1206; H.R. 3081, 106th Cong. § 306; H.R. 1102, 106th Cong. § 109; S. 741, 106th Cong. § 110.

196. I.R.C. § 4975(f)(6) (1994 & Supp. IV 1998).

197. H.R. 2488, 106th Cong. § 1202; H.R. 3081, 106th Cong. § 302; H.R. 1102, 106th Cong. § 102; S. 741, 106th Cong. § 101.

198. Joint Committee on Taxation Summary and Revenue Estimates on Conference Agreement on H.R. 2488, Taxpayer Refund and Relief Act of 1999, JCX-61-99R, at 9 (Aug. 5, 1999).

199. See discussion *supra* Part I.C.3.

200. See H.R. 2488, 106th Cong. § 1231-33; H.R. 3081, 106th Cong. §§ 331-33; S. 8, 106th Cong. § 445-47; H.R. 1102, 106th Cong. §§ 301-302; S. 741, 106th Cong. §§ 301-302; H.R. 1590, 106th Cong. §§ 305-306; H.R. 1213, 106th Cong. §§ 12-14; H.R. 739, 106th Cong. §§ 2-3; S. 1357, 106th Cong. §§ 2-3 (1999).

201. See H.R. 2488, 106th Cong. § 1224; H.R. 3081, 106th Cong. § 324; H.R. 1102, 106th Cong. § 205; S. 741, 106th Cong. § 206.

202. See H.R. 2488, 106th Cong. § 1251; H.R. 3081, 106th Cong. § 361.

203. See H.R. 2488, 106th Cong. § 1256; H.R. 3081, 106th Cong. § 366.

ures.²⁰⁴ These simplification proposals would streamline and reduce the employer's administrative responsibilities in sponsoring a qualified plan at a minimal cost in terms of lost revenues.²⁰⁵

The top-heavy rules are another target for administrative simplification. Proposed legislation would extend the exemption from the top-heavy rules for SIMPLE plans to all 401(k) plans that are exempt from nondiscrimination testing because the employer makes a specified level of matching contributions to the plan.²⁰⁶ In addition, the rules for determining key employees and top-heavy status would be simplified, most notably by repealing the family aggregation rules and ignoring 401(k) plan salary deferrals when determining top-heavy status.²⁰⁷ This proposed change would result in an estimated revenue loss of \$123 million for 2000 to 2009.²⁰⁸

The special nondiscrimination rules for 401(k) plans are a third target for administrative simplification. Under current law a 401(k) plan is exempt from ADP testing if the employer makes a contribution for each non-highly compensated eligible employee equal to three percent of the employee's compensation.²⁰⁹ Proposed legislation would reduce this minimum employer contribution to one percent, thereby making safe harbor treatment more affordable for sponsors of 401(k) plans.²¹⁰ Other proposed legislation would exempt the employer's 401(k) plan from ADP testing if the employer adopts an "automatic enrollment" feature in its 401(k) plan.²¹¹ The result of expanding the scope of the ADP testing exemption would be to allow more highly compensated employees to contribute the maximum allowable amount for salary deferrals to their 401(k) plans.

Other proposed changes appear to increase the administrative burden associated with sponsoring 401(k) plans. In particular, plan administrators would have to monitor which participants are eligible to make catch-up contributions to the 401(k) plan.²¹² Separate record-keeping and accounting will be necessary to keep track of excess contributions that the employee elects to be treated as qualified plus (after-tax) contributions to the 401(k) plan.²¹³ The investment earnings attributable to these qualified plus contributions

204. See H.R. 2488, 106th Cong. § 1257; H.R. 3081, 106th Cong. § 367.

205. See *Summary and Revenue Estimates on H.R. 2488*, *supra* note 152, at 10-11. The changes to the direct rollover rules would result in an estimated revenue loss from 2000 to 2009 of \$106 million. All of the other proposals for simplification are estimated to have a "negligible revenue effect." See *id.*

206. See H.R. 2488, 106th Cong. § 1203; H.R. 3081, 106th Cong. § 303.

207. See H.R. 2488, 106th Cong. § 1203; H.R. 3081, 106th Cong. § 303; H.R. 1102, 106th Cong. § 104; S. 741, 106th Cong. § 104.

208. *Summary and Revenue Estimates on H.R. 2488*, *supra* note 152, at 9.

209. I.R.C. § 401(k)(12)(B) (1994 & Supp. IV 1998).

210. See S.8, 106th Cong. § 422; H.R. 1213, 106th Cong. § 7.

211. See H.R. 1102, 106th Cong. § 110; S. 741, 106th Cong. § 114. Under an "automatic enrollment" 401(k) plan, the employer automatically withholds a specified percentage (typically 3%) of each eligible employee's compensation unless and until the employee affirmatively elects not to make salary deferral contributions to the plan. See Profit Sharing/401(k) Council of America, *Automatic Enrollment 2000*, (March 2, 2000) (visited Oct. 3, 2000) <<http://www.pscsca.org/PSCAAutoenroll.pdf>>.

212. See H.R. 2488, 106th Cong. §§ 214, 1221; H.R. 3081, 106th Cong. § 321; H.R. 1546, 106th Cong. § 401; H.R. 1102, 106th Cong. § 201; S. 649, 106th Cong. § 401; S. 646, 106th Cong. § 401; S. 2671, 106th Cong. § 201.

213. See H.R. 2488, 106th Cong. § 1208; H.R. 3081, 106th Cong. § 308; H.R. 1546, 106th Cong. § 201; H.R. 1102, 106th Cong. § 112; S. 649, 106th Cong. § 201; S. 646, 106th Cong. § 201; S. 2671, 106th Cong. §

also must be accounted for separately from the employee's earnings on tax-deferred salary deferral contributions.²¹⁴ Thus simplification in some aspects of 401(k) plan administration may be offset by more complex administrative duties in these areas.

B. Critique of the Proposals

Current proposals to reform the pension tax laws would result in a substantial increase in the pension tax expenditure.²¹⁵ Some of the proposed reforms are revenue-neutral efforts to simplify the law,²¹⁶ but many of the proposals are designed to reverse and go beyond the changes to the limitations rules that occurred during the deficit cycle years.²¹⁷ Despite the reductions in the maximum limits on qualified plan contributions and benefits during the deficit cycle, the pension tax expenditure grew to \$78.3 billion in 2000.²¹⁸ The potentially dramatic impact on the fisc of these proposals for pension tax law reform raises significant public policy questions. What will taxpaying workers gain from this reallocation of public resources? What will be the distributional effect of these proposed reforms? Are the proposed reforms fiscally sustainable in the long term? What are the implications of these proposed reforms for national retirement policy in the future? Unfortunately, as Professor Graetz and others have pointed out, lawmakers in Congress have little incentive (other than a sense of personal moral obligation) to seek answers to these types of tax policy questions under the current structure of the budget process.²¹⁹ This problem is exacerbated in the context of pension tax law reform. Presumably many voters can understand and therefore react, positively or negatively, to proposals to reform the personal income tax system. Only pension tax law experts are likely to comprehend the impact of changes to the pension tax laws.²²⁰ Subpart B of the article examines and attempts to answer the difficult questions posed above that lawmakers have been unwilling, or unable, to face.

1. Distributional Effects of Proposed Reforms

Several studies have examined the distributional characteristics of the pension tax laws.²²¹ Significantly, these studies all are based on 1992 data--a point in time after the most dramatic decreases in the contribution and benefit limits for qualified plans had been implemented.²²² Not surprisingly, these studies found that the deficit cycle amend-

104; *Summary of the Revenue Provisions of the Conference Agreement on H.R. 2488, The Taxpayer Refund and Relief Act of 1999*, " 21, Joint Comm. on Taxation, JCX-66-99 (Aug. 6, 1999).

²¹⁴. See *id.*

²¹⁵. *Summary and Revenue Estimates on H.R. 2488*, *supra* note 152. The Joint Committee on Taxation estimates a revenue loss of \$14,874,000 for 2000 to 2009 for the pension reform proposals in H.R. 2488. This figure does not include an additional estimated revenue loss of \$33,382,000 resulting from proposed changes to the rules governing IRAs. See *id.* at 2-3, 11.

²¹⁶. See, e.g., *supra* notes 200-204 and accompanying text.

²¹⁷. See discussion *supra* Part II.A.1.

²¹⁸. See *Estimates of Federal Tax Expenditures, 1999-2003*, *supra* note 91, at 23.

²¹⁹. See sources cited *supra* note 84.

²²⁰. Even the pension tax law experts find it difficult to absorb the changes in the pension tax laws. See Helm & Goldstein, *supra* note 95.

²²¹. See *FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS*, *supra* note 93, at 443-44; Salisbury, *supra* note 27, at 94-95 and Table 5.7; Schieber & Goodfellow, *supra* note 27, at 112-113.

²²². See *id.*

ments to the pension tax laws had resulted in a more equitable system.²²³ As a result of these changes, a greater portion of the pension tax expenditure was reallocated from high-income households (over \$200,000) to upper-middle income (\$50,000-\$100,000) and middle-income (\$30,000-\$50,000) households.²²⁴

Middle-income households gain the most from pension tax incentives. Taxable returns showing income between \$30,000 and \$50,000 (29 percent of taxable returns) paid 18 percent of taxes, received 28 percent of the pension tax incentive value, and could experience an 18 percent tax increase if the incentives were removed. Upper middle-income households at \$50,000 to \$100,000 (24 percent of taxable returns) paid 33 percent of taxes, received 43 percent of the tax expenditure, and could experience a 15 percent tax increase with the end of pension incentives.²²⁵

Raising the current statutory compensation cap of \$150,000, along with the other proposed liberalizations of the limitations rules, will reverse the trend toward a more equitable distribution of the pension tax subsidy. Higher limits on 401(k) salary deferrals are particularly likely to benefit higher income workers who have more discretionary income to save for retirement.²²⁶ Perhaps more pernicious for lower-income workers is the proposal to allow Roth IRA-like income tax treatment for the excess contributions of highly compensated employees to 401(k) plans.²²⁷ If enacted, this proposal would provide an incentive to lower the deferral amounts of non-highly compensated employees in the 401(k) plan. By lowering the actual deferral percentage of the non-highly compensated employees, highly compensated employees will receive tax-free investment earnings on a larger portion of their salary deferral contributions.²²⁸ For highly compensated employees, the economic benefit of tax-free investment earnings compounded over a long period of time is likely to far outweigh the relatively minimal loss of a current income tax deduction on salary deferral contributions to the plan.²²⁹

Several of the proposals to simplify plan administration are likely to increase the dis-

223. *See id.*

224. *See id.*

225. Salisbury, *supra* note 27, at 94-95.

226. *See The Evolution of Retirement*, *supra* note 21, at 11 (among persons who reported not yet having begun to save for retirement, the overwhelming reason cited (66%) was having too many current financial responsibilities). The Center on Budget and Policy Priorities, citing data from the Institute for Taxation and Economic Policy, has asserted that

"76.9 percent of the pension and IRA tax reductions from the provisions [of H.R. 1102, 106th Cong.] would accrue to the 20 percent of Americans with the highest income. Similarly, the institute said more than 42 percent of the pension and IRA tax breaks would go to the 5 percent of the population with the highest incomes, while the bottom 60 percent of the population would receive less than 5 percent of the tax benefits."

Pensions: Ways and Means Committee Approves Pension Bill, Rejects Democratic Substitute Amendment, [2000] DAILY TAX REP. (BNA) G-2, G-3 (July 14, 2000), available in WL 136 DTRG-2, 2000.

227. *See supra* notes 175-176 and accompanying text.

228. *See sources cited supra* notes 175-176.

229. In his article, *The Time Value of Money*, Halperin conclusively demonstrated that the true tax benefits of 401(k) plan contributions are not from the immediate income tax deduction, but rather from earning a pre-tax rate of return on investment earnings that compound inside the plan. *See Daniel I. Halperin, Interest In Disguise: Taxing the Time Value of Money*, 95 YALE L. J. 506, 520-24 (1986) (discussed in Halperin, *supra* note 9, at 2, note 4). Allowing these investment earnings to be withdrawn tax-free would provide a tremendous tax savings to highly compensated employees because these earnings are likely to far outweigh the after-tax contributions made to the plan. *See infra* text accompanying note 276 (example of George and Maria).

tributional inequities of the pension tax law system. Although sometimes cumbersome to administer, the top-heavy rules for all plans and ADP testing for 401(k) plans have a distributional function. Both operate to allocate more of the pension tax subsidy to rank-and-file workers. The top-heavy rules force the sponsor of a top-heavy plan to increase the contributions or benefits of non-key employees.²³⁰ The ADP test reduces the level of elective salary deferrals by highly compensated employees, but places no such restrictions on non-highly compensated employees.²³¹ Exempting more plans from these rules will undermine the effect of these distributional mechanisms.

Another aspect of distributional equity is the scope of pension plan coverage among workers by income group. None of the current proposals for reform would require sponsors of pre-existing qualified plans to expand the scope of plan coverage.²³² Instead, the proposals focus on incentives to encourage new plan sponsorship, primarily among smaller employers.²³³ These incentives for new plan sponsorship among smaller employers are unlikely to be effective in expanding the scope of pension coverage.

The proposed SAFE plan initiative²³⁴ is unlikely to stimulate new plan sponsorship among smaller employers. The SAFE plan is premised on the assumption that the primary deterrent to sponsorship of defined benefit plans among smaller employers is the burden of plan administration.²³⁵ Recent research on smaller employers, however, indicates that uncertain business revenues are a much more important factor than ease of plan administration in the smaller employer's decision to sponsor a retirement plan.²³⁶ Moreover, SAFE defined benefit plans are uniquely ill-suited for smaller employers. The fixed cost to the employer in terms of an annual full funding obligation and the assumption of investment risk makes them inflexible and thus unattractive to smaller employers whose revenue levels may fluctuate from year to year.²³⁷

In summary, a closer examination of the distributional effects of proposed pension tax law reforms indicates that many of the proposals are unlikely to expand retirement plan coverage to workers who currently have none. Nor are these proposals likely to enhance the retirement income security of low-income workers. Rather, these proposals are likely to enhance the benefits of higher income employees who already participate in a retirement plan. The likely result will be an increase in the distributional inequities of

230. See I.R.C. § 416 (1994 & Supp. IV 1998). These rules also force the employer to vest the benefits of non-key employees on an accelerated basis. See generally, U.S. GEN. ACCOUNTING OFFICE, "TOP-HEAVY RULES," *supra* note 135, at 6-20.

231. See I.R.C. § 401(k)(3)(A)(ii) (1994 & Supp. IV 1998); Treas. Reg. § 1.401(k)-1(b)(2) (as amended in 1995).

232. See sources cited *supra* note 149.

233. See discussion *supra* Part II.A.2.-3.

234. See discussion *supra* Part II.A.2.

235. See discussion *infra* Part III.A.

236. See discussion *infra* Part III.B.2. The other key motivating factor for plan sponsorship among smaller employers is employee demand. See discussion *infra* Part III.B.2.

237. One small manufacturing business owner, testifying before Congress, explained his decision to establish a profit-sharing rather than defined benefit plan as follows:

I haven't given a defined benefit plan any true thought. I felt like the only way I could fund it in the beginning was that if I had a company profit I knew I wanted to share it. So, therefore, I elected to go with a profit sharing type of plan.

I didn't feel like, as a small businessman, I could afford the unknown cost.

Hearing on Defusing the Retirement Time Bomb, *supra* note 136, at 160 (testimony of Bruce Young III, President, Stainless Metal Products, Inc.).

the pension tax law system.²³⁸

2. Fiscal Sustainability of the Proposed Reforms

The pension tax law system is frequently criticized because Congress's constant revision of the rules makes compliance by employers expensive and difficult.²³⁹ Similarly, the qualified plan rules are constantly criticized as being too "complex."²⁴⁰ Part I of this article described how these symptoms of constant change and resulting complexity are the product of deficit cycle amendments designed to reduce the amount of the pension tax expenditure.²⁴¹ The proposed reforms to the pension tax laws treat these symptoms, but not their underlying cause. To the contrary, the proposed reforms, if enacted, are likely to make the pension tax laws even more sensitive to the federal budget balancing process in future years.

Over 60% of the current budgetary surplus is attributable to Social Security contributions that exceed required Social Security benefit payments. The Congressional Budget Office reports that of the estimated \$232 billion budget surplus in 2000, \$149 billion is due to "off-budget" accounts that consist mainly of Social Security trust funds.²⁴² In the future, however, an economic downturn, a decline in the level of surplus Social Security contributions relative to benefits, or a combination of the two, will create another budget deficit cycle. Assuming the proposed reforms have been enacted by that time, the pension tax expenditure will have grown to be an even larger, more inviting target in the federal budget balancing process. Another round of "reform" amendments seems inevitable during the next deficit cycle in the federal budget.

The policy approach exemplified by SIMPLE and SAFE plans only adds to the overall complexity of the pension tax laws.²⁴³ Although creating another set of qualified plan rules would increase the options available to smaller employers, it also adds another layer of detail for pension tax law experts to master and employers to puzzle over. This approach makes the pension tax law system as a whole more, not less, complex. Moreover, viewed from the perspective of the individual smaller employer, these "simple" rules are, in fact, not so simple.²⁴⁴ The smaller employer who outgrows his eligibil-

238. The distributional inequities of the pension tax law system are, of course, somewhat offset by the progressive benefits structure of Social Security, that disproportionately benefits low-income workers. See Graetz, *Paint-By-Numbers*, *supra* note 84, at 658; Goodfellow & Schieber, *supra* note 9, at 163-70 (analyzing the combined distributional effect of Social Security and the pension tax expenditure). Measured in absolute dollars, however, even the maximum Social Security monthly benefit (\$1,433 in 2000) provides a meager income. See Social Security Administration, *Fact Sheet: 2000 Social Security Changes* (revised Apr. 26, 2000) (visited Oct. 3, 2000) <<http://www.ssa.gov/pressoffice/2000colafact.htm>>. Retired workers today will receive on the average a monthly benefit of \$804. See *id.* Justifying the distributional inequities of the pension tax system by countering with the progressive structure of Social Security is possible only if policymakers are willing to separate the problem of elderly poverty from national retirement policy. The difficulty with this approach is that at a budgetary level the two issues become intertwined. A larger pension tax expenditure constrains other federal spending programs, including programs aimed at the problem of elderly poverty.

239. See Halperin, *supra* note 9, at 6. See Helm & Goldstein, *supra* note 95.

240. See sources cited *supra* note 239.

241. See discussion *supra* Part I.C.

242. See The Budget and Economic Outlook: An Update, *supra* note 6, CHAP. ONE at 1.

243. See discussion *supra* Part I.C. & II.A.2.

244. See Kovach, *supra* note 142.

ity limit of 100 employees, or who has become profitable enough to sponsor another qualified plan, must transition to another set of qualified plan rules.²⁴⁵ I explain in Part III why imposing such transition costs on the growth of smaller employees ultimately is counterproductive to the goal of enhancing retirement income security for low-income workers.²⁴⁶ Finally, continuing the SIMPLE plan approach by enacting its proposed defined benefit twin, the SAFE plan, means that during the next deficit cycle Congress will have not one, not two, but three sets of qualified plan rules based solely on employer size to "reform."

Perhaps most importantly, cyclical amendments to the pension tax laws undermine one of the important, but often overlooked, functions of ERISA.²⁴⁷ One of the purposes of ERISA's disclosure rules is to provide information to plan participants so that they can make rational decisions in planning and saving for retirement.²⁴⁸ Constant change in the limitations rules undermines this ability of plan participants rationally to engage in long-term retirement planning. The importance of this rationale planning function will only continue to grow in the future as more workers save for retirement through 401(k) plans.²⁴⁹

A plan participant who has engaged in retirement planning will be pleasantly surprised if, sometime in the future as he nears retirement, the rules governing qualified plans are changed so that his contributions to or benefits from the retirement plan are more generous than he originally planned. In contrast, if the qualified plan rules are changed so that his contributions to or benefits from the retirement plan are less than he has planned for, the participant may not have sufficient time or income remaining until retirement to make up the shortfall in his projected level of retirement income. From a participant planning perspective, it is crucial to know whether the current state of the pension tax laws will continue throughout one's working career.

Assuming the proposed reforms are enacted, who is most likely to be "caught," and thus harmed, by the next round of deficit cycle amendments designed to reduce the pension tax expenditure? In the short run, the expansion of Roth IRAs and the incorporation of Roth-like features in 401(k) plans will generate tax revenues and thus help to offset the loss of tax revenues from other changes to the pension tax laws.²⁵⁰ Because lawmakers are not accountable under the procedures of the budget balancing process for the long-term future revenue losses attributable to the tax-free withdrawals of investment earnings from Roth IRAs or Roth-like 401(k) plans, it is easy (and politically expedient) for them to lose sight of (or not even consider) the long-term consequences for national retirement policy. The adverse revenue impact of these tax-free withdrawals of invest-

245. See *supra* notes 142 & 183 and accompanying text. The size of the employer would continue to be measured on a controlled group or common control basis, thereby preventing employers from circumventing the 100 employee limitation through the creation of subsidiaries. See I.R.C. § 414 (b),(c) (1994 & Supp. IV 1998).

246. See discussion *infra* Part III.B.2.

247. See *supra* note 1.

248. See Peter J. Wiedenbeck, *Implementing ERISA: Of Policies and "Plans,"* 72 WASH. U. L. Q. 559, 568 (1994).

249. See Medill, *supra* note 21, at 7-9.

250. See Stretching the Pension Dollar, *supra* note 40, at 25.

ment earnings will begin to be felt when the baby boomer generation retires.²⁵¹ This timing coincides, of course, with the beginning of the budgetary pressures predicted for the time when the baby boomers will begin receiving Social Security benefits in large numbers. Thus it appears likely that the generations of younger workers who follow after the baby boomers will be the group who suddenly must operate under a new and more restrictive set of qualified plan rules. It is this same group who also is likely to bear the increased costs of Social Security benefits for the baby boomer generation.²⁵²

In summary, the potential of proposed reforms to drain the fisc is likely to exaggerate the cyclical effects of the budget balancing process on pension tax policy. These cycles are detrimental because they undermine the predictability and stability of qualified plans for both sponsoring employers and plan participants. As discussed in the next section, these proposals also potentially jeopardize popular potential support among younger generations for another key component of national retirement policy--the Social Security system.

3. Implications of Proposed Reforms for Social Security Policy

"Looking at each element of the retirement system without consideration of the others is a bit like three blind men describing an elephant when one had hold of the trunk, the second had hold of an ear, and the third had hold of a leg."²⁵³

The pension tax laws interact with the Social Security system to form two of the three major components of national retirement policy.²⁵⁴ The controversy surrounding the future financial crisis facing of Social Security raises long-debated, complex issues that are beyond the scope of this article.²⁵⁵ This section focuses on the discrete question of how proposed changes to the pension tax laws may affect, and in turn be affected by,

251. In contrast to Roth IRAs and proposed Roth-like 401(k) plans, an owner of a traditional IRA or a participant in a 401(k) plan is subject to personal income tax when he withdraws contributions and investment earnings. See *supra* notes 81-82 and accompanying text. To the extent Roth IRAs and Roth-like 401(k) plans supplant traditional IRAs and 401(k) plans, the fisc will lose tax revenues in the future as participants make income tax-free withdrawals, presumably at retirement.

252. See sources cited *infra* note 278.

253. Goodfellow & Schieber, *supra* note 9, at 127.

254. See Graetz, *supra* note 3.

255. See generally United States General Accounting Office, Report to the Committee on Finance, U.S. Senate, Social Security: Different Approaches for Addressing Problem Solvency (July 1998); Prospects For Social Security Reform (Olivia S. Mitchell, et al., eds. 1999); Framing the Social Security Debate: Values, Politics, And Economics (R. Douglas Arnold, et al., eds., 1998); Social Security In The 21st Century (Eric R. Kingdon and James H. Schulz, eds., 1997); C. Eugene Steuerle and Jon M. Bakija, Retooling Social Security For The 21st Century: Right And Wrong Approaches to Reform (1994); Robert J. Myers, Social Security (4th ed. 1993); Charles W. Meyer and Nancy Wolff, Social Security and Individual Equity: Evolving Standards Of Equity And Adequacy (1993); Social Security: Prospects For Real Reform (Peter J. Ferrara, ed., 1985); Kathryn L. Moore, *Partial Privatization of Social Security: Assessing Its Effect on Women, Minorities, and Low-Income Workers*, 65 Mo. L. Rev. 341 (2000); Robert H. Binstock, *Public Policies on Aging in the Twenty-First Century*, 9 Stan. L. & Pol'y Rev. 311 (1998); Kathryn L. Moore, *Privatization of Social Security: Misguided Reform*, 71 Temple L. Rev. 131 (1998); Robert Greenstein, *Reform Social Security*, The Nation, June 21, 1999 at 5; Robert J. Barro, *Don't Tinker with Social Security, Reinvent it*, Bus. Week, June 8, 1998 at 24. Once a taboo topic for all politicians, Social Security reform became a central issue in the 2000 presidential campaign. See generally Richard W. Stevenson, *Political Memo: Social Security, That Risky Issue, Is On The Table*, New York Times News Service (June 22, 2000) (2000 WL-23203068).

Social Security. Over 60% of the budget surplus that has sparked proposals to reform the pension tax laws is attributable to the current surplus in the Social Security trust funds.²⁵⁶ Absent reform, according to a recent report of the Social Security Board of Trustees, the Social Security trust funds will be depleted in 2037²⁵⁷ shortly after the last of the "baby boom" generation retires.²⁵⁸ Thereafter, payroll contributions for Social Security will be sufficient to pay only 72% of promised Social Security benefits.²⁵⁹ Just as the Social Security system accounts for most of today's budget surplus, unless reformed in the future it is likely to account for most of a substantial budget deficit.²⁶⁰ A budget deficit cycle predictably will trigger another round of pension tax law reforms designed to reduce the size of the pension tax expenditure.²⁶¹ Consequently, the future of Social Security reform is likely to determine whether today's proposals for pension reform, if enacted, are fiscally sustainable.

Another key intersection of the proposed pension tax law reforms with Social Security arises because of Social Security's transfer of wealth from younger to older generations.²⁶² This intergenerational wealth transfer issue prompts both skepticism of the So-

256. See *supra* note 242 (\$149 billion/\$232 billion = 64%).

257. See Social Security Administration, *News Release: Social Security Trust Funds Gain Three Additional Years of Solvency* (March 30, 2000) (visited October 3, 2000).

<<http://www.ssa.gov/pressoffice/3solvency.htm>>; Social Security Administration, *Status of the Social Security and Medicare Programs: A Summary of the 2000 Annual Reports*, 9 (Rev. April 2000) (visited Oct. 3, 2000) <<http://www.ssa.gov>>. Analysts disagree about the exact date upon which the OASDI's trust funds will be depleted, with the projected dates for depletion ranging from 2029-2037. Analysts agree, however, that after the trust funds are depleted, incoming funds, primarily in the form of payroll taxes, will only be able to supply three-fourths (3/4) of required outlays. See *Preparing Americans for Retirement: The Roadblocks to Increased Savings: Joint Hearing Before the Senate Special Comm. On Aging and the House Subcomm. On Employer-Employee Relations*, 105th Cong. 2 (1998) (statement of Senator Charles E. Grassley, Chairman); Michael J. Boskin, *A Framework for Considering Social Security Reform*, in *FRAMING THE SOCIAL SECURITY DEBATE*, *supra* note 255, 29, 32; Olivia S. Mitchell, et al., *An Overview of the Issues*, in *PROSPECTS FOR REFORM*, *supra* note 255, 3, 6; Edward M. Gramlich, *The United States: How to Deal with Uncovered Future Social Security Liabilities*, 64 *BROOK. L. REV.* 739 (1998); Moore, *supra* note 255 at 132.

258. The "baby boom" generation is defined as those people born from 1946-1964. See Binstock, *supra* note 255 at 311.

259. See Status of the Social Security and Medicare Programs, *supra* note 257, at 9; see generally Social Security Program Solvency, in *DIFFERENT APPROACHES FOR ADDRESSING PROBLEM SOLVENCY*, *supra* note 255 at 33; Hugh Heclo, A Political Science Perspective on Social Security Reform, in *FRAMING THE SOCIAL SECURITY DEBATE*, *supra* note 255, 65, 77; STEUERLE AND BAKIJA, *supra* note 255 at 3; Mitchell, *supra* note 257 at 10; Moore, *supra* note 255, 71 *TEMPLE L. REV.* at 143; William H. Simon, Rights and Redistribution in the Welfare System, 38 *STAN. L. REV.* 1431, 1469 (1986).

260. Currently, Social Security, Medicare, and Medicaid account for 40% of all federal spending. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2010*, 7 (Jan. 2000) (visited Oct. 3, 2000) <<http://www.cbo.gov>>. Medicare and Medicaid are closely related to Social Security as a three-pronged social safety net for the elderly. Medicare subsidizes medical care for the elderly. Medicaid subsidizes custodial (nursing home) care for the indigent elderly. The Congressional Budget Office estimates that by the year 2030, these three programs will account for more than two-thirds of all federal spending. See *id.*

261. See *supra* Part I.C.2.

262. See SOCIAL SECURITY PROGRAM SOLVENCY, *supra* note 255 at 7; Heclo, *supra* note 259 at 79; Binstock, *supra* note 255 at 313; Simon, *supra* note 261 at 1457, 1470; Meyer, *supra* note 255 at 22; Marilyn Moon, *Are Social Security Benefits Too High or Too Low?*, in *SOCIAL SECURITY IN THE 21ST CENTURY*, *supra* note 255, at 71; Theodore R. Marmor, et al., *Social Security Politics and the Conflict Between Generations*, in *SOCIAL SECURITY IN THE 21ST CENTURY*, *supra* note 255, at 195; STEUERLE & BAKIJA, *supra* note 255 at 108; Joseph F. Quinn, *Criteria for Evaluating Social Security Reform*, in *PROSPECTS FOR SOCIAL SECURITY REFORM*, *supra* note 255; Stephen G. Kellison & Marilyn Moon, *New Opportunities for the Social Security System*, in *PROSPECTS FOR REFORM*, *supra* note 255, 60, 65; John Geanakoplos, et al., *Social Security Money's*

cial Security system among younger workers²⁶³ and proposals to "privatize" Social Security.²⁶⁴ As the ratio of contributions paid to benefits received continues to fall for younger workers,²⁶⁵ popular political support for Social Security among this group is likely to decline.²⁶⁶

Current pension tax law proposals to allow additional "catch-up" contributions to 401(k) plans for persons age 50 and older²⁶⁷ exacerbate the generational inequities already present in the Social Security system. Such provisions explicitly allocate more of

Worth, in PROSPECTS FOR REFORM, *supra* note 255, 80; Kathryn L. Moore, *Redistribution Under a Partially Privatized Social Security System*, 64 BROOK. L. REV. 974 (1998); Moore, *supra* note 255, 71 TEMPLE L. REV. at 143; Michael J. Boskin, et al., *Social Security: A Financial Appraisal Across and Within Generations*, 40 NAT'L TAX J. 19, 22-26 (1987); Maria O'Brien Hylton, *Evaluating the Case for Social Security Reform: Elderly Poverty, Paternalism, and Private Pensions*, 64 BROOK. L. REV. 749, 755 (1998); Paul Craig Roberts, *The Social Security Shell Game*, WASH. TIMES, Nov. 2, 1999 at A14; *No Alternative: the Contract Between the Generations Needs Renegotiating, Not Ditching*, THE ECONOMIST, Jan. 27, 1996 at S16; Robert J. Samuelson, *Justice Among Generations: Stocks Won't Spare Us From Cuts in Social Security and Medicare*, NEWSWEEK, Jan. 20, 1997 at 29; *Social Security has Become a Giant Pyramid Scheme*, BUS. WEEK, Oct. 10, 1988 at 28.

263. Interestingly, although younger workers generally are not confident that Social Security benefits will exist for them during their retirement, at present they nevertheless support the system because they see the how their elderly relatives benefit from the system and recognize its importance as a social safety net for low-income retirees. See Lawrence R. Jacobs & Robert Y. Shapiro, *Myths and Misunderstandings About Public Opinion Toward Social Security*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 255 at 357; Quinn, *supra* note 262 at 46; *Introduction*, in PROSPECTS FOR REFORM, *supra* note 255 at 7; Eric R. Kingson & James H. Schultz, *Preface*, in SOCIAL SECURITY IN THE 21ST CENTURY, *supra* note 255, at xii; Kingson, *supra* note 255 at 178, 183; MYERS, *supra* note 255 at 459; Gramlich, *supra* note 257 at 744.

264. See SOCIAL SECURITY PROGRAM SOLVENCY, *supra* note 255 at 5; Moore, *supra* note 262 at 971, 977; Heclo, *supra* note 259 at 67; Kent A. Smetters, *Thinking About Social Security's Trust Fund*, in PROSPECTS FOR REFORM, *supra* note 255, 201, 212; Robert C. Pozen & John M. Kimpel, *Investments and Administrative Constraints on Individual Social Security Accounts*, in PROSPECTS FOR REFORM, *supra* note 255 at 372; John C. Goodman, *Private Alternatives to Social Security: The Experience of Other Countries*, in PROSPECTS FOR REAL REFORM, *supra* note 255, 103; Peter J. Ferrara, *Social Security Reform: Some Theoretical Considerations*, in PROSPECTS FOR REAL REFORM, *supra* note 255, 173; John Geanakoplos, et al., *Would a Privatized Social Security System Really Pay a Higher Rate of Return?*, in FRAMING THE DEBATE, *supra* note 255, 137, 138; Lawrence H. Thompson, *Individual Uncertainty in Retirement Income Planning under Different Public Pension Regimes*, in FRAMING THE DEBATE, *supra* note 255, 113; Binstock, *supra* note 255 at 315-16; Moore, *supra* note 255 at 132, 148-9; Simon, *supra* note 259 at 1446-7, 1485; Gramlich, *supra* note 257 at 746; Jane Bryant Quinn, *Are Private Social Security Accounts Practical?*, WASH. POST, Nov. 8, 1998 at HO2.

265. See MYERS, *supra* note 255 at 512; Gramlich, *supra* note 257 at 743; Kingson, *supra* note 255 at 76, 275; *Introduction*, in FRAMING THE SOCIAL SECURITY DEBATE, *supra* note 255 at 1.

Dilley criticizes this "money's worth" analysis of Social Security contributions versus benefits on broader policy grounds. She argues that:

[t]he proper measure of redistribution [of Social Security dollars] is not how contributions compare to benefits but instead how the benefits paid out to low-wage workers compare to the level of income needed to maintain an independent life at retirement, at an income level comparable to--or even improving on for those at the bottom of the wage scale--the income level while working.

Dilley, *supra* note 7, at 1185. Others would treat the problem of working career poverty carrying over into retirement poverty as separate and distinct from questions of national retirement policy. See Gratz, *supra* note 3, at 856, n. 9.

266. See Gramlich, *supra* note 257, at 744; Robert J. Myers, *Will Social Security Be There For Me?*, in SOCIAL SECURITY IN 21ST CENTURY, *supra* note 255, 208. Heclo, *supra* note 259 at 66, 81; Jacobs and Shapiro, *supra* note 263 at 358, 364-5; Simon, *supra* note 255 at 1469; Quinn, *supra* note 264 at 50-51.

267. See discussion *supra* Part II.A.1.

the pension tax expenditure to the babyboomer generation.²⁶⁸ Proponents of the concept of catch-up provisions argue that workers who are approaching the end of their working careers are at their earnings peak and are better positioned to save for retirement.²⁶⁹ Allowing persons age 50 or older the opportunity to make additional 401(k) plan salary deferrals, proponents argue, will enhance the retirement income security of workers, particularly women, who were unable to save for retirement earlier in their career because of child-rearing responsibilities or more pressing current financial responsibilities.²⁷⁰

Perhaps catch-up contributions could be justified as promoting overall national retirement policy if they were limited to persons who are in danger of having inadequate retirement income. As currently proposed, however, the sole eligibility criterion for catch-up provisions is age.²⁷¹ There is no test for eligibility based on the individual's income or net worth.²⁷² Allowing catch-up contributions for every worker who has attained age 50 will increase the distributional inequities of the pension tax law system.²⁷³ It is the workers with higher incomes who are most likely to utilize the higher contribution limits allowed under the catch-up provisions.

The catch-up provisions also encourage behavior among younger workers that undermines the overall policy goal of enabling workers to achieve an adequate income during retirement. Allowing catch-up contributions encourages the (mis)perception among younger workers that they do not need to begin saving large amounts for retirement until later in their working careers.²⁷⁴ In fact, just the opposite is true. Younger workers will be much better prepared for retirement if they saved smaller amounts early in their working careers. The following example, taken from the *Complete Idiot's Guide to 401(k) Plans*,²⁷⁵ illustrates the point.

George and Maria are both age 20.] Maria decides to save \$2,500 each year for 10 years. George, on the other hand, says "I'll wait, I'm young and have plenty of time." (Sound familiar?) So he saves nothing.

At age 30, they reverse roles Maria stops saving and George starts to save \$2,500 a year. They continue this strategy for the next 35 years, with each earning an 8 percent annual return on their money. Our question for you: Who has more money at age 65? George or Maria?

You would think it's George. After all, he saved over three times what Maria did--\$87,500 versus \$25,000. But Maria's ahead at age 65. She has over \$114,000 more (\$535,472) than George does (\$430,792), even though she saved \$62,500 less.²⁷⁶

268. See *id.*

269. See CONG. REC. S 10310 (daily ed. Aug. 5, 1999) (Statement of Sen. Hutchinson); CONG. REC. H 846 (daily ed. Mar. 9, 2000) (Statement of Rep. Johnson); Kovach, *supra* note 142, at 422.

270. See sources cited *supra* note 269. Thus the catch-up provisions are characterized in proposed legislation as pension reforms "enhancing fairness for women." See, e.g., H.R. 2488, 106th Cong., Title XII, Subtitle B.

271. See sources cited *supra* note 169.

272. See sources cited *supra* note 169.

273. See discussion *supra* Part II.B.1.

274. See *The Evolution of Retirement*, *supra* note 21, at 11-13. The 1999 Retirement Confidence Survey found that among persons who had not yet begun saving for retirement, 24% cited as a major reason why that "lots of time remains until retirement." See *id.* at 11. Among Generation X workers *not currently saving* for retirement, 78% (more than any other generational group) reported that *it would be possible* for them to save \$20 a week for retirement. See *id.* at 12-13.

275. Wayne G. Bogosian & Dee Lee, *The Complete Idiot's Guide to 401(k) Plans* (1998).

276. See *id.* at 43-44.

Finally, it is doubtful that catch-up provisions are fiscally sustainable in the long term. Allowing them will greatly increase the pension tax expenditure.²⁷⁷ Their inevitable repeal during a future deficit cycle will fuel the intergenerational tensions that already exist in national retirement policy as a result of the structure of Social Security. Young workers, already likely to be bearing the burden of increased Social Security and Medicare payroll taxes for baby boomer retirees,²⁷⁸ will only become further disenchanted when the catch-up contributions they have relied upon to fund their own retirement are repealed.

IV. TARGETED PENSION REFORM

"Thus, in order to evaluate current tax policy accurately, it is important to know whether the tax benefits of qualified plans truly lead to a significant increase in coverage, or whether non-tax reasons so dominate that the tax incentives are of relatively minor importance."²⁷⁹

In his article, *A New Dynamics of Tax Policy?*,²⁸⁰ Pollack describes how tax experts in the government bureaucracy, outside experts from public policy think tanks, tax policy "entrepreneurs,"²⁸¹ and lobbying groups play a significant role in the formation of tax policy.²⁸² The influence of these players in the policy process lies in their ability to shape and determine the menu of alternatives (proposed legislation) from which congressional lawmakers must choose to address a perceived problem of public policy.²⁸³ Pollack describes how, prior to the enactment of the Tax Reform Act of 1986, a shared "ideology" concerning tax reform developed among and dominated the thinking of middle and high level government tax bureaucrats and outside tax experts.²⁸⁴ When congressional lawmakers became interested in enacting tax reform, according to Pollack it was this shared ideology that dominated the legislative agenda and eventually resulted in the Tax Reform Act of 1986.²⁸⁵

A similar ideological movement today appears to underlie current legislative proposals for pension tax law reform.²⁸⁶ I describe this movement as the "traditional approach"

277. See *supra* note 171 and accompanying text.

278. See SOCIAL SECURITY PROGRAM SOLVENCY, *supra* note 255 at 5, 20, 34; Binstock, *supra* note 255 at 315; Introduction, in PROSPECTS FOR REAL REFORM, *supra* note 255 at 2; STEUERLE & BAKUA, *supra* note 255 at 159; John Rother & William E. Wright, *Americans' Views of Social Security and Social Security Reforms*, in PROSPECTS FOR REFORM, *supra* note 255, 380, 385; Peter A. Diamond, *The Economics of Social Security Reform*, in FRAMING THE DEBATE, *supra* note 255, 38, 39; Edward M. Gramlich, *discussion*, in FRAMING THE DEBATE, *supra* note 255 at 424; Gramlich, *supra* note 257 at 741; Hylton, *supra* note 262 at 750, 755; Moore, *supra* note 255, 71 TEMPLE L. REV. at 145.

279. Halperin, *supra* note 9, at 7.

280. See Pollack, *supra* note 84.

281. Pollack describes a policy "entrepreneur" as follows: "The policy entrepreneur peddles ideas--often ideas that have been in the air for decades, but which find a place on the policy agenda as some political figure finds it convenient and appealing to promote such issue at that particular time." *Id.* at 74.

282. See *id.* at 69-84.

283. See *id.* at 69-71.

284. See *id.* at 71-72.

285. See *id.* at 70.

286. Certainly most of the characteristic players described by Pollack are present in the current movement for pension tax law reform. Senator Roth is an example of the classic tax policy entrepreneur. Experts regularly have testified before Congress on pension reform. See *Portman Praises GOP Tax Bill; Study Shows Need for Pension Reform*, DAILY TAX REP. G-3 (Aug. 11, 1999). Lobbying groups also have been active in

to pension tax reform. Although numerous bills to reform the pension tax laws have been introduced in Congress, Part II's analysis reveals that *there is at present no vigorous public debate over alternatives for pension tax reform*. Proposed reforms all offer similar, if not identical, solutions to expanding the scope of retirement plan coverage.

Parts III and IV of the article introduce an alternative to the traditional approach, *targeted pension reform*, which would expand retirement plan coverage for rank-and-file workers. In the process, targeted pension reform would improve the distributional equities of the pension tax law system.

Part III develops a theoretical foundation for targeted pension reform (the "targeted reform theory"). This theoretical foundation focuses on the factors influencing the employer's decision-making process for voluntary plan sponsorship and plan coverage design. Part IV builds upon this theoretical foundation by offering an alternative legislative proposal designed to achieve the goals of targeted pension reform.

A. Flawed Assumptions Underlying the Traditional Approach to Pension Reform

Both government and outside experts in the pension field have expressed concern that the scope of retirement plan coverage, expressed as a percentage of the workforce, has remained stagnant at around 50% of the workforce.²⁸⁷ The traditional approach assumes that pension plan coverage has failed to expand in scope because Congress reduced the tax incentives and benefits for employers and highly-compensated employees.²⁸⁸ In the process, these amendments made pension tax law more "complex," thereby increasing the administrative costs of plan sponsorship and further deterring employers from sponsoring retirement plans.²⁸⁹ These two interrelated assumptions underlie the traditional approach to pension tax reform.

The traditional approach to pension reform evolved with the nondiscrimination rules governing retirement plans.²⁹⁰ Historically pension plans began as an employer benefit

shaping proposals for reform. The SAFE defined benefit plan is being promoted by the American Society of Pension Actuaries. The Council for Capital Formation and the Association of Private Pension and Welfare Plans, two groups representing large employers, commissioned the *Stretching the Pension Dollar*, *supra* note 40, that lawmakers have relied upon in shaping and promoting proposed legislation. The proposed reforms contained in this study have been directly incorporated into pension reform legislation. Compare *Stretching the Pension Dollar*, *supra* note 40, with discussion of proposed reform legislation, *supra* Part II.A.

287. See sources cited *supra* note 9.

288. See, e.g., Michael J. Gulotta, *Changing Private Pension Funding Rules and Benefit Security*, in PENSION FUNDING & TAXATION, *supra* note 27, at 119-124 (characterizing changes to the funding and deduction rules as "break[ing] the bond between executives, who decide on funding policy for these plans, and the vast majority of plan participants."); IRAs, 401(k) Plans, and Other Savings Proposals, *supra* note 136, at 21 (testimony of John Mothey, National Federation of Independent Businesses).

289. See, e.g., Edwin C. Hustead, *Trends in Retirement Income Plan Administrative Expenses*, in LIVING WITH DEFINED CONTRIBUTION PLANS, 166-77 (Olivia S. Mitchell & Sylvester J. Schieber, eds. 1998); MCGILL, *supra* note 63, at 39-42.

290. See I.R.C. §§ 401(a)(4) (1994), 410(b) (1994 & Supp. IV 1998); Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 426-29 (1984) (describing historical evolution and purposes of the nondiscrimination rules prior to the changes made by the Tax Reform Act of 1986); Michael W. Melton, *Making the Nondiscrimination Rules of Tax-qualified Plans More Efficient*, 71 BOSTON U. L. REV. 47 (1991) (describing the nondiscrimination rules as amended by the Tax Reform Act of 1986).

available only to a small group of high-level management employees of the employer.²⁹¹ The nondiscrimination rules forced employers to cover a broader range of employees in their retirement plans.²⁹² Essentially, coverage of lower paid employees became the "price" that the employer must pay for the highly paid management employees to receive their tax-subsidized retirement plan benefits.

An inherent policy tension exists between encouraging employers to provide for retirement income for their employees, and placing limitations on the loss in tax revenues that results from retirement plans.²⁹³ As a matter of national retirement policy we want to encourage employers to sponsor plans that will provide retirement income and thus offer a tax subsidy to encourage such employer behavior. But this tax subsidy and the resulting drain on the fisc are difficult to justify unless retirement plan coverage and benefits are made available to rank-and-file employees.

The traditional approach relies heavily on the circumstance that the highly compensated employees generally are the same employees who are managing the company and making decisions about plan sponsorship and design. The underlying premise of the traditional approach is that the greater the tax subsidy personally available to these highly compensated employees, the more willing they will be to have the business pay the price for nondiscrimination. It is this assumption that underlies current proposals to reform the pension tax law system.²⁹⁴ If reducing the employer's tax subsidy for sponsoring a retirement plan and the associated tax benefits for highly compensated employees during the deficit cycle caused plan coverage to stagnate, then (lawmakers assume) reversing these changes to allow for more generous tax incentives necessarily (lawmakers hope) will result in expanded retirement plan coverage.

Will increasing the pension tax incentives for highly compensated employees result in expanded pension coverage for rank-and-file workers? One test of a theory's ability to predict the future is its ability to explain the past. The assumptions that underlie the traditional approach to pension reform fail this test. These assumptions are inconsistent with current trends²⁹⁵ in retirement plan sponsorship and coverage design.

First, the traditional approach fails to explain the tendency of larger employers to exclude low-income workers from retirement plan coverage.²⁹⁶ Under the traditional approach, employers are motivated to sponsor retirement plans because they want to obtain the benefits for their highly compensated employees. The least costly way for the employer to obtain qualified plan benefits for its highly compensated employees is to include the required number of non-highly compensated employees by starting at the

291. See Wolk, *supra* note 290, at 426-28.

292. See WIEDENBECK & OSGOOD, *supra* note 62, at 203-05.

293. See *id.* at 427-29.

294. See discussion *supra* Part II.A.

295. The assumptions that underlie the traditional approach, along with fundamental structural change in the United States economy, do appear to explain the historical decline of defined benefit plans. See Medill, *supra* note 21, at 6, note 24. There is some evidence that sponsorship of defined benefit plans in the past was heavily influenced by the employer's tax subsidy, and that reducing the amount of this subsidy caused a decline in the number of defined benefit plans. See Robert L. Clark, Ann A. McDermed & Michelle White Trawick, *Firm Choice of Type of Pension Plan: Trends and Determinants*, in *THE FUTURE OF PENSIONS*, *supra* note 9, 115-116.

296. See discussion *supra* Part I.A.

bottom of the compensation scale and working upwards. This approach minimizes the employer's costs because the employer's contributions to a qualified plan generally are a function of each participant's compensation.²⁹⁷ Thus, based on the assumptions of the traditional approach one would expect to see a coverage pattern that included low-income workers and excluded workers in the middle of the salary scale (the employees at the upper range of the non-highly compensated employees' compensation scale). But the empirical data, at least at an aggregate level, indicate that this is not what many employers do.²⁹⁸ The coverage pattern is generally to include the higher paid workers and exclude the lower paid workers from plan coverage.²⁹⁹

Second, the continued phenomenal growth of 401(k) plans since 1986 undermines the ability of the traditional approach to predict employer behavior.³⁰⁰ The special non-discrimination rules for 401(k) plans enacted by the Tax Reform Act of 1986 had two effects. Significant limitations were placed on the ability of highly compensated employees to make salary deferrals to the plan.³⁰¹ These limitations often reduced the level of salary deferral contributions for highly compensated employees to far below the maximum amount allowed to non-highly compensated employees.³⁰² In addition, the administrative burden on employers of complying with these more stringent nondiscrimination rules for 401(k) plans increased significantly.³⁰³ Given these two effects, the traditional approach would predict that 401(k) plans should have at least slowed in popularity after the Tax Reform Act of 1986. Instead, 401(k) plans have continued to grow in popularity among employers.³⁰⁴ In 1995 (the most recent figures available), 55% of all contributions to retirement plans were to 401(k) plans.³⁰⁵

Finally, the traditional approach does not explain the overwhelming popularity of 401(k) plans among employers having fewer than 100 employees.³⁰⁶ Congress did not enact simplified rules for 401(k) plans sponsored by these smaller employers until the Small Business Job Protection Act of 1996.³⁰⁷ Prior to the enactment of these simplified rules, smaller employers sponsoring 401(k) plans were subject to the same special non-discrimination rules as larger employers.³⁰⁸ Yet despite the reduced and uncertain level of benefits available to highly compensated employees and the increased administrative burden, 401(k) plans became the retirement plan of choice among smaller employers.³⁰⁹

297. See I.R.C. § 401(a)(4) (1994).

298. See discussion *supra* Part I.A. There are exceptions that aggregate level data will mask. A classic example is the law firm retirement plan that covers only partners of the firm and staff, but excludes associate attorneys. See ALI-ABA, *Pension, Profit-Sharing, Welfare, and Other Compensation Plans*, Vol. I, 355 (March 22-24) (case study example of retirement program for law firm).

299. See sources cited *supra* note 19 and accompanying Table 1 (Coverage Rates by Occupation).

300. See Medill, *supra* note 21, at 7-9.

301. See sources cited *supra* note 77 and accompanying text.

302. See *id.*

303. See discussion *supra* text and accompanying notes 124-127. For an example of the complex legal and accounting analysis that may be used to minimize the effects of a 401(k) plan with a "bad" ADP testing result, see the case study in ALI-ABA, *supra* note 298, at 377-392.

304. See Medill, *supra* note 21, at 7.

305. See *Stretching the Pension Dollar*, *supra* note 40, at 9.

306. See *infra* note 358 and accompanying text.

307. See *supra* notes 142-143.

308. See I.R.C. § 401(k) (1994 & Supp. IV 1998).

309. See 1994 FORM 5500 ANNUAL REPORTS, *supra* note 9, Table D.4 at 48; SMALL PRIVATE ESTABLISHMENTS, *supra* note 11, at 78.

The inability of the traditional approach to explain recent trends in pension plan sponsorship and coverage design makes it an inappropriate foundation for pension reform legislation. One fundamental flaw is its failure to recognize and incorporate the traditional employee recruitment and retention functions of employer-sponsored benefit plans.³¹⁰ A second fundamental flaw is its monolithic and overly simplistic analysis of the employer's motivations for sponsoring a retirement plan. A more sophisticated theoretical analysis would view employers as making a multi-faceted business decision in a specific business context. The targeted reform theory utilizes this more sophisticated approach.

B. A Theoretical Foundation For Targeted Pension Reform

The targeted reform theory is based on the premise that the employer's decision-making process for plan sponsorship and coverage design, and the factors that influence those decisions, will vary according to the employer's legal structure. Legal structure has two key components under the targeted reform theory. First, legal structure may determine how the business entity is taxed. Second, legal structure determines the employer's mechanisms for entity governance. The targeted reform theory describes how both of these components play a critical role in the employer's decision-making process for plan sponsorship and coverage design.

Why focus on legal structure and its implications for decision-making? The decision to sponsor or amend a retirement plan is one that voluntarily must be made *by the employer*.³¹¹ How does an employer legally act? What motivates the employer to voluntarily sponsor a plan, and to include and exclude various groups of employees from plan coverage? By focusing on the taxation and governance aspects of the employer's legal structure, the targeted reform theory provides significant insights into the answers to these fundamental questions.

The discussion below develops the targeted reform theory of how the employer's particular legal structure influences retirement plan coverage. It describes and analyzes three different business legal structures selected as representative models of the range of employers in the United States.³¹² First, I examine publicly traded corporations, the area where corporate governance theory has been the most well-developed by scholars.³¹³

310. See MCGILL, *supra* note 63, at 442-51; *infra* notes 348-350 and accompanying text; Halperin, *supra* note 9, at 3, 8-11.

311. See *supra* note 29 and accompanying text.

312. My categories of representative employers are consistent with the analysis used by corporate governance scholars. Allan Blake categorizes companies based on their type of ownership. Blake's categories of "family," "quasi-partnership," and "entrepreneur" correspond to my owner-employee business and closely held corporation models, *supra* Parts III.B.2.-3. His category of "listed" companies and "subsidiaries within a group of companies" correspond to my publicly traded corporation model and its "M-form" variant, *supra* Part III.B.1. Using these categories, Blake analyzes and compares the corporate governance role of board of directors in each of these categories. See ALLAN BLAKE, DYNAMIC DIRECTORS, 27-27, 37 (1999). Abbass Alkafaji divides privately held companies into two types. See ABBASS F. ALKAFAJI, A STAKEHOLDER APPROACH TO CORPORATE GOVERNANCE, 17 (1989). His "owner-managed" and "family-owned" private companies correspond to my owner-employee business and closely held corporation models. See *id.*

313. See generally CORPORATE GOVERNANCE (Kevin Keasey, Steve Thompson & Mike Wright, ed. 1997); ROBERT A.G. MONKS & NELL MINOW, WATCHING THE WATCHERS: CORPORATE GOVERNANCE FOR

Next, I examine employers that are owned by a single or small number of persons, and that are organized as conduit entities for taxation purposes ("owner-employee businesses"). Finally, I examine non-publicly traded corporations having both majority and minority shareholders ("closely held corporations").

1. Publicly Traded Corporations

The publicly traded corporation model has two distinguishing characteristics. First, a publicly traded corporation is treated for tax purposes as a separate taxable entity.³¹⁴ Second, the publicly traded corporation is operated by professional managers who are distinct from the numerous shareholders who own the business.³¹⁵ A shareholder-elected board of directors is responsible for overseeing the professional managers of the business.³¹⁶

Publicly traded corporations are likely to fall within the category of larger employers having 100 or more employees.³¹⁷ The data indicate that these employers generally do sponsor retirement plans, but these plans are designed to exclude certain groups of workers, in particular low-income workers, from coverage.³¹⁸

If a publicly traded corporation were to amend its established retirement plan to include more workers, what legal action would be necessary? For reasons of ERISA fiduciary liability, plan amendments are made (or at least ratified) by a resolution approved by the board of directors of the corporation.³¹⁹ What motivates action by the board of directors in a publicly traded corporation? Corporate law posits that because the board members are the elected representatives of the shareholders, the board should take actions that ensure the corporation is financially successful, thereby maximizing shareholder value.³²⁰ In reality, directors of many publicly traded corporations traditionally were (and some still are) "passive." These passive boards act only at the recommenda-

THE 21ST CENTURY (1996); Sanjai Bhagut, Dennis C. Corey & Charles M. Elson, *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885 (1999).

314. See Treas. Reg. § 301.7701-2(b); AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, TAXATION OF PRIVATE BUSINESS ENTERPRISES, REPORTERS' STUDY, 67-68 (George K. Yin & David J. Shakoŵ, Reporters) (July 1999) (describing entity versus conduit theories of taxation of business enterprises). Under current law, certain publicly traded firms organized as partnerships may be separately taxed as corporations under Subchapter C of the Code. See I.R.C. § 7704(a) (1994 & Supp. IV 1998); REPORTERS' STUDY, *supra*, at 57-58, 117-18.

315. See ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, 4-5 (1932); Bhagut, Carey & Elson, *supra* note 313, at 886-887; Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool To Focus Reform*, 35 WAKE FOREST L. REV. 153, 158-59 (2000).

316. See 8 Del. Code § 141(a); R. Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of Corporations and Business Organizations, § 4.1 (3rd Ed. 1998); Berle & Means, *supra* note 315, at 69-70, 220; Bhagut, Carey & Elson, *supra* note 313, at 891.

317. See *supra* note 11 and accompanying text.

318. See discussion *supra* Part I.A.

319. Plan amendment by the employer is a settlor function that is not subject to fiduciary liability under ERISA. See *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 443-44 (1999); *Lockheed Corp. v. Spinks*, 517 U.S. 882, 890 (1996); *Curtis-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 78 (1995) (noting that an employer or other plan sponsor is "generally free under ERISA...to adopt, modify or terminate welfare plans."). ERISA recognizes traditional principles of corporate law that a corporation "acts" through its board of directors or authorized agents. *Curtis-Wright Corp.*, 514 U.S. at 77-81.

320. See DYNAMIC DIRECTORS, *supra* note 312, at 27-29; Robert B. Thompson, *Shareholders As Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV. 990, 1005 (1999).

tion of the top management executives of the corporation, typically the chief executive officer.³²¹

In the modern publicly traded corporation, the interests of top level management are not naturally aligned with the interests of the shareholders in maximizing shareholder wealth.³²² Corporate governance theory³²³ has sparked a movement among shareholders of publicly traded corporations to remedy this problem. Executive compensation plans are designed to create incentives that tie compensation of the corporation's top level management to share value.³²⁴ Outside directors are encouraged, or in some instances required, to invest substantial sums in the stock of the corporation.³²⁵ These trends, combined with the growing importance of the institutional investor,³²⁶ have led to an intensified focus by both executive management and directors on the short-term financial performance of the publicly traded corporation.³²⁷ This intense pressure to boost short-term

321. See BERLE & MEANS, *supra* note 315, at 89; Bhugart, Carey & Elson, *supra* note 313, at 887-891.

322. See BERLE & MEANS, *supra* note 315, at 121-22.

323. The meaning and scope of the term "corporate governance" varies widely. "In its narrowest sense, the term may describe the formal system of accountability of senior management to the shareholders. At its most expansive the term is stretched to include the entire network of formal and informal relations involving the corporate sector and their consequences for society in general." Kevin Keasey, Steve Thompson & Mike Wright, *Introduction: The Corporate Governance Problem--Competing Diagnoses and Solutions*, in CORPORATE GOVERNANCE, *supra* note 313, at 2. Monks and Minow define corporate governance as "the relationship among various participants in determining the direction and performance of corporations." MONKS & MINOW, *supra* note 313, at xvii. They define the "primary" participants as shareholders, management, and the board of directors. See *id.* A more recent variant of corporate governance theory, the "stakeholder" theory, would require the corporation's board of directors to take into account a broader range of constituent interests, whether or not these interests were related to share value. See BLAKE, *supra* note 312, at 27-29; see generally ALKAFASI, *supra* note 312.

324. See BLAKE, *supra* note 312, at 143; Randall S. Thomas & Kenneth F. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1030-31 (1999); Jennifer G. Hill, *Deconstructing Sunbeam--Contemporary Issues in Corporate Governance*, 67 U. CIN. L. REV. 1099, 1120 (1999); Robert Dean Ellis, *Equity Derivatives, Executive Compensation, and Agency Costs*, 35 HOUS. L. REV. 399, 413 (1998); Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 U. PA. J. LAB. & EMP. REV. 227, 233-38 (1999).

325. See Charles M. Elson, *Director Compensation and the Management-Captured Board--The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996); *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649 (1995); Hill, *supra* note 324, at 1112 ("directors [of Sunbeam Corporation] were required to purchase a 'significant tranche' of Sunbeam stock from their own funds before then appointment to the board").

326. See MONKS & MINOW, *supra* note 313, at 106-19; William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1088-91 (1999); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 567-70 (1990); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2078 (1994); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); Carol B. Swanson, *Corporate Governance: Sliding Seamlessly Into the Twenty-First Century*, 21 J. CORP. L. 417, 423 (1996). Chandler, a leading jurist on the Delaware Court of Chancery, defines institutional investors as "those stock- and debt-holding groups or entities that actively invest on behalf of others. Among the entities that might fall into this category are: pension funds; mutual funds; venture and culture capital partnerships; insurance companies; and commercial banks and other financial institutions." Chandler, *supra*, at 1083, note 3.

327. See MONKS & MINOW, *supra* note 313, at 106-19, 232-38 (explaining why various types of institutional investors and corporate management are focused on short-term corporate performance); Chandler, *supra* note 326, at 1092-93; Thomas & Martin, *supra* note 324, at 1035 (mutual fund shareholders focus on liquidity of investments and their short-term performance); Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1893 (1992) (noting that institutional investors are

corporate earnings characterizes the publicly traded corporation of today.³²⁸ I propose that it also strongly influences employer decisions concerning retirement plan coverage.

The traditional approach to pension reform assumes that the management decision makers for the employer are motivated to sponsor qualified plans in order to obtain preferential tax benefits for themselves. As an initial observation, the millions of dollars in compensation paid to many chief executives and other senior officers of publicly traded corporations make laughable the idea that higher qualified plan benefit limits will motivate their decisions.³²⁹ Putting this observation aside, according to the underlying logic of the traditional approach, the retirement plans of publicly traded corporations should tend to cover only the highest and lowest-paid employees. This coverage design is the least costly way to obtain the qualified plan benefits for the highly compensated management employees.³³⁰ But the empirical data indicate that this is not how larger corporations appear to act.³³¹ Large corporations tend to exclude from their retirement plans the "cheapest" workers (low-income workers) and include the most "expensive" workers to cover (those who are at the higher end of the non-highly compensated employee compensation scale).³³² Why this approach? An alternative explanation is that the publicly traded corporation will target the most marginalized, lowest-skilled segments of its workforce for exclusion. It is this population of workers who are the least valuable to the operation of the business and whose resulting job dissatisfaction is *least likely to impact corporate profits adversely in the short term*.

Publicly traded corporations compete in the national labor market for the limited pool of educated and highly-skilled employees who are vital to the financial success of the business.³³³ To be able to attract and retain these valued workers, the employer must offer retirement plan benefits to them. To not do so would put the employer at a com-

unwilling to invest in corporate governance changes that have uncertain immediate returns); Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 88-89 (describing tax Code incentives for shift from salaries to stock options and other performance-based compensation for executives of public corporations); Thomas & Martin, *supra* note 324, at 1029 (describing dramatic growth of the value of stock option grants to corporate executives).

328. Indeed, the pressure today for public corporations to meet Wall Street earnings expectations is so great that Securities and Exchange Commission (SEC) Chairman Arthur Levit publicly commented that it may be leading to accounting manipulation bordering on fraud. See Hill, *supra* note 324, at 1124-25. At the urging of the SEC, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers voluntarily formed a committee ("Committee") to investigate SEC concerns with corporate financing reporting practices. See Ira M. Millstein, *Introduction to the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1057, 1057-58 (1999). The Committee determined the SEC's concerns with the quality of corporate financial reporting were real, and were "primarily fueled by a perceived need for corporations to constantly 'make the numbers'--to match or exceed analysts' expectations and projections." *Id.* at 1059. The NYSE has adopted the recommended reforms of the committee and requires compliance by its member corporations.

329. Compare Stabile, *supra* note 327, at 81-82 and notes 1-5 (describing compensation of chief executives and senior officers), with Table 4 (Proposals to Change the Limitations Rules), *supra* notes 150-162 (proposed upper limits for benefits and contributions for participants in qualified plans). See generally GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* (1991).

330. This is because both the benefits payable to each participant in a defined benefit plan and the contributions made by the employer for each participant are a function of and limited by the participant's compensation. See I.R.C. §§ 404, 415 (1994). The lower the level of the participant's compensation, the lesser the level of benefits payable or contributions made in absolute dollars for that participant.

331. See Table 1 (Coverage Rates by Occupation), *supra* note 19.

332. See *id.*

333. See MCGILL ET. AL., *supra* note 63, at 339.

petitive disadvantage, because its competitors are offering retirement plan benefits as part of their compensation package offers.³³⁴ For purposes of the pension tax law rules for plan coverage, this group of workers will tend to be either highly-compensated employees or those workers who are at the higher end of the non-highly compensated employee compensation scale.³³⁵ In contrast, there is a greatly reduced employer demand for part-time workers or low-skilled workers. Retirement plan benefits are much less essential for the publicly traded corporation to fill these positions.³³⁶

How the publicly traded corporation arrives at the coverage design of its retirement plan also will be determined by its particular business history. Significant events in the corporation's business history, such as the purchase or sale of subsidiaries or divisions, the unionization of its workforce, or the growth and expansion of its business can provoke a reexamination of retirement plan coverage to determine whether the plan continues to satisfy the tax rules for qualified plans.³³⁷ Each such reexamination, and if necessary, plan amendment(s), will be sparked by some change in the underlying business operations. An expansion of plan coverage will increase the corporation's operating expenses in the form of additional administrative costs and/or increased employer contributions to the plan. Increased expenses will reduce corporate earnings. This adverse impact on corporate earnings makes it highly unlikely that the publicly traded corporation will expand the scope of retirement plan coverage to cover low-income workers beyond the minimum legal requirements mandated by the pension tax laws.

In a publicly traded corporation with a passive board of directors, the board acts only at the initiative and upon the recommendation of the top-level management.³³⁸ Due to the structure of their executive compensation packages, top-level management are unlikely to recommend any action with a detrimental effect on short-term corporate profits. Increasing plan coverage will result in an immediate, definite and easily quantified increase in the operating expenses of the business. The short term impact on corporate profits will be a negative one.

Expanding plan coverage to low-income workers can improve productivity and thereby boost corporate profits in the longer term. These benefits result from higher levels of job satisfaction, higher employee morale, lower rates of employee turnover, and a mechanism to encourage older, less productive workers to retire.³³⁹ But such beneficial effects are difficult to estimate in terms of dollars and, most important of all, will

334. See *id.*; see generally Mandelker, *supra* note 41, at 74 (describing intense competition among employers for high-tech employees).

335. See *supra* notes 54-55 and accompanying text.

336. Offering retirement benefits to low-income workers may actually make it more difficult for the corporation to fill these positions because this group is least likely to accept any reduction in current wages in exchange for retirement plan benefits. See Halperin, *supra* note 9, at 14.

337. See discussion *supra* Part I.B.2. Large public corporations tend to divide into multiple divisions, each with its own separate administrative and managerial employees. See Hicheon Kim & Robert E. Hoskisson, *Market (United States) Versus Managed (Japanese) Governance*, in *CORPORATE GOVERNANCE*, *supra* note 313 at CHAP. 8, 174-78; ALKAFASI, *supra* note 312, at 19. This "M-form" organizational structure makes the large public corporation uniquely suited to take advantage of the separate line of business exception to the coverage rules. See sources cited *supra* notes 66-70 and accompanying text.

338. See Stabile, *supra* note 315, at 170 n. 77.

339. See MCGILL ET AL., *supra* note 63, at 461-77; LANGBEIN & WOLK, *supra* note 53, at 29-32.

become evident only in the long term. In a fast-paced, ever changing business environment driven by last quarter's reported earnings, a benefit that will not materialize until several years in the future is simply too long to wait.

For similar reasons, even a publicly traded corporation with an activist board of directors is unlikely to initiate expanded pension coverage for low-income workers. The intricacies of qualified plan coverage design and the pension tax laws are likely to be beyond the expertise of most directors.³⁴⁰ Outside directors in particular are unlikely to have the time, information, inclination, and expertise necessary to raise the issue of expanding the coverage under employer's retirement plan.³⁴¹ Activist shareholder groups, particularly institutional investors, put continual pressure on board members to boost short-term corporate financial performance.³⁴² Even for those directors who have a significant personal investment in the corporation's stock,³⁴³ the uncertain financial impact on the corporation of expanding plan coverage is likely to deter such initiatives.

In summary, the targeted reform theory indicates answers to two key questions in the publicly traded corporation setting. It explains why a publicly traded corporation will exclude low-income workers from qualified plan coverage. It also explains why a publicly traded corporation is unlikely to expand pension coverage voluntarily beyond the minimum level required by the pension tax laws. The pressure for short-term corporate earnings constrains any attempt by management, directors, and institutional shareholders to voluntarily expand pension coverage. Only governmental compulsion, in the form of more inclusive minimum coverage requirements under the pension tax laws, will motivate the publicly traded corporation to expand pension coverage to low-income workers.

Congress can compel expanded retirement plan coverage by amending the coverage rules for qualified plans. Such amendments would bring into sharp conflict the inherent tension between employer choice and governmental regulation in a system dependent upon voluntary plan sponsorship by employers. I confront this persistent policy dilemma in Part III.C, and show why a fear of plan terminations by employers in response to more inclusive coverage rules is unrealistic.

2. Owner-Employee Businesses

The owner-employee business model has two distinguishing characteristics. First, for federal income tax purposes it is generally treated as a "conduit" rather than separately taxed. Tax items of the entity "flow through" to its owners and are taken into account directly by the owner(s).³⁴⁴ Second, in the owner-employee business model, the

340. See *supra* note 111 and accompanying text; cf. Stabile, *supra* note 315, at 170 n. 74. ("Board members sitting on a company's compensation committee are generally not compensation experts. Typically, board members include university deans, doctors, lawyers, and other professionals who may or may not have significant business experience but who rarely possess any expertise in compensation matters.") As Professor Stabile has pointed out, in addition to a lack of expertise, outside directors of large publicly traded corporations also may be under significant time constraints. See *id.* at 175-76 & n. 95.

341. See ALKAFASI, *supra* note 312, at 51-52.

342. See sources cited *supra* notes 327-328. The irony of this situation is that by far the largest group of institutional investors, in terms of asset holdings, are in fact private pension funds. See MONKS & MINOW, *supra* note 313, at 106, 119.

343. See sources cited *supra* note 326.

344. See REPORTERS' STUDY, *supra* note 314, at 43, 67-68. Employers treated as conduits for taxation purposes include entities taxed under subchapter K of the Code and entities that have elected to be governed

owner is also the top managerial (and likely the highest paid) employee of the business.³⁴⁵

The unique governance characteristic of owner-employee business model is the unity of ownership and management. As both controlling owner and top management employee, one individual (or a small group of individuals)³⁴⁶ decides whether the business will sponsor a retirement plan. What motivates the owner-employee of a business to sponsor a retirement plan? A recent survey of smaller employers helps answer this question.³⁴⁷ The two most important reasons cited by survey respondents for sponsoring a retirement plan were first the competitive advantage plan sponsorship gave the business in recruiting and retaining employees, and second the positive effect on employee attitude and performance.³⁴⁸ The third most significant reason cited by smaller employers was the moral obligation of employers to provide a retirement plan for their employees.³⁴⁹ According to survey respondents, the tax benefits to employees in general,

under subchapter S of the Code ("S corporations"). See *id.* According to the U.S. Census Bureau, as of 1992 there were a total of 3,135,000 sole proprietorships, partnerships, and S corporations employing a total of 27,403,000 employees. See U.S. CENSUS BUREAU, *Statistics about Small Business and Large Business from the U.S. Census Bureau*, Table 4 (visited Oct. 3, 2000) <<http://www.census.gov/epcd/www/smallbus.html>>.

To elect S corporation status, a corporation must be a domestic corporation with only one class of stock having no more than 75 shareholders. All shareholders must be either individuals, estates or certain permitted trusts, and no shareholder may be a nonresident alien. See I.R.C. § 1361 (1994 & Supp. IV 1998). Prior to 1996, the number of permitted shareholders was 35. See JAMES S. EUSTICE & JOEL D. KUNTZ, *FEDERAL INCOME TAXATION OF S CORPORATIONS*, ¶ 3.04[1] at 3-90 (3rd Ed. 1993). Maine estimates that as of 1997 S corporations constituted 48% of all corporations in the United States. See Jeffrey A. Maine, *Evaluating Subchapter S In a "Check-The-Box" World*, 51 *TAX LAW* 717, 724-25 (1998). Domestic limited liability companies are taxed as partnerships unless they affirmatively elect to be taxed as S or C corporations. See *Treas. Reg.* § 301.7701-3(b)(1) (as amended in 1996); Maine, *supra*, at 726-35. Due to recent tax regulatory developments, in the future limited liability companies taxed as partnerships under Subchapter K are likely to grow in importance. See *id.* at 730-35. For a comparison of the taxation features of Subchapters K and S, see *REPORTERS' STUDY*, *supra* note 314, Table 1 at 129-30.

345. See ALKAFASI, *supra* note 312, at 17. In his study of individual income tax returns reporting partnership or subchapter S net income, Yin found that only 6% of the returns reported having an adjusted gross income of less than \$40,000, which represents a rough proxy for individual taxpayers in the 15% or lower tax bracket. See George K. Yin, *The Future Taxation of Private Business Firms*, 4 *FLA. TAX REV.* 144, 180-182 (1999). Using 1994 tax return data, Yin and Shakow estimated that roughly 62.6% of returns reporting partnership or S corporation income were filed by taxpayers in the 28% or higher income tax bracket. See *REPORTERS' STUDY*, *supra* note 314, at 139-42. When analyzed as a percentage of net income, only 6% of total partnership or S corporation net income was reported by taxpayers in the 15% of lower income tax bracket. See *id.* at 143-45.

346. As of 1997, 51% of all S corporations in the United States had only one shareholder. See Maine, *supra* note 344, at 724-25. Another example of the owner-employee business model is a "family company" where ownership is limited to the members of a family who also work in the business. See BLAKE, *supra* note 312, at 99.

347. Employee Benefit Research Institute, *supra* note 12.

348. See *id.* at 6-7 and Table 2. Thirty-three percent of employers cited competitive advantage in employee retention and recruitment as the most important reason to sponsor a retirement plan, and sixty percent (60%) cited it as a major reason. Twenty-eight percent (28%) of employers cited the positive effect on employee attitude and performance as the most important reason to sponsor a retirement plan, and seventy-one percent (71%) cited it as a major reason.

349. See *id.* Twelve percent of employers cited this moral obligation as the most important reason to sponsor a retirement plan, and twenty-nine percent (29%) cited it as a major reason. This response is particularly interesting because it is not captured by an analysis based on economically rational decision-making. This third reason is consistent, however, with the consolidation of ownership and management in one individ-

and the tax benefits to "key" employees of the business, were much less important reasons to sponsor a retirement plan.³⁵⁰

The survey also provides insights into why owner-employee businesses chose not to sponsor a retirement plan. Contrary to the traditional approach, the survey found that "[t]here are a number of reasons why more small employers do not offer retirement plans--it is not simply a matter of administrative cost and burden."³⁵¹ One major reason is that business revenues are too uncertain to commit to a plan.³⁵² The other major reason is lack of employee demand for a retirement plan. If the employer has a large number of seasonal, part-time, or high-turnover employees, or the employees prefer wages or other types of employer-provided benefits to retirement plan benefits, the employer is unlikely to choose to sponsor a retirement plan.³⁵³

The taxation and governance characteristics of the owner-employee business model explain these survey results. The owner-employee's personal income is directly linked to

ual and the likely influence of the individual's personal values on business decision-making. It may also reflect the family-owned nature of many of these types of businesses.

350. Employment Benefit Research Institute, *supra* note 12, at 6-7 and Table 2. Only seven percent (7%) of employers cited the tax advantages to employees as the most important reason to sponsor a retirement plan, and six percent (6%) of employers cited the tax advantages to key employees as the most important reason to sponsor a retirement plan. Thirty-eight percent (38%) cited the tax advantages to employees as a major reason, and twenty-five percent (25%) cited the tax advantages to key employees as a major reason.

A simple cost-benefit analysis explains why the immediate income tax benefits alone are unlikely to persuade an owner-employee to sponsor a retirement plan. The maximum annual contribution the owner-employee can make to a 401(k) plan is a salary deferral limited to \$6,000 if a SIMPLE plan is used, or \$10,000 if a safe harbor 401(k) plan is selected. The owner-employee will realize a minimal immediate savings in his income taxes due to the contribution. Assuming the owner-employee is in a 40% marginal income tax bracket (combined federal and state), on a \$6,000 SIMPLE plan contribution the owner-employee will have an income tax savings of \$2,400.

What is the "cost" to the owner-employee of sponsoring the plan and obtaining this "tax benefit"? For either type of 401(k) plan design selected, to make the maximum annual contribution the owner-employee must contribute a "safe harbor" amount to the 401(k) plan. Assuming the owner-employee selects the most simple safe harbor to administer, the owner-employee must contribute an amount roughly equal to 3% of compensation for the employees of the business who are eligible to participate in the 401(k) plan. In addition, the owner-employee will incur administrative expenses for sponsoring the plan. Taken together, these two factors constitute the "costs" to the owner-employee of sponsoring the plan. Because the business is treated as a conduit entity for tax purposes, these costs directly reduce the personal income of the owner-employee.

By choosing not to sponsor a 401(k) plan, the owner-employee also will "save" the "costs" of contributions for the other eligible employees and plan administration. Again, because tax items of the business are accounted for by the owner individually, these "savings" directly increase the personal income of the owner-employee.

Simple math indicates that the immediate income tax savings to the owner-employee are very likely to be overwhelmed by the countervailing immediate costs of employer contributions and plan administration. Even assuming that the plan's administrative costs are zero, once the payroll costs for the owner-employee's other employees exceed \$80,000, the costs of contributions to the plan for those employees will exceed the owner-employee's personal immediate income tax savings from sponsoring the plan.

351. *Id.* at 4. Only fifteen percent (15%) of employers indicated that the most important reason for not sponsoring a retirement plan was that it cost too much to set up and administer or that there were too many government regulations. *See id.* at 5.

352. *See id.* at 5 and Table 1. Nineteen percent (19%) of employers cited revenues as the most important reason for not sponsoring a retirement plan. Fifty percent (50%) of employers cited revenues as a major reason they did not sponsor a retirement plan.

353. *See id.* Nineteen percent (19%) of employers cited seasonal, part-time, or high-turnover workers as the most important reason for not sponsoring a plan, and forty-two percent (42%) listed it as a major reason. Seventeen percent (17%) of employers cited an employee preference for wages or other benefits as the most important reason not to sponsor a retirement plan, and fifty-three percent (53%) cited it as a major reason.

the financial success of the business. To increase her personal earnings, the owner-employee must grow and expand the business in a profitable manner. Business growth and expansion, however, require capital. Business revenues can be used directly to finance expansion. Business revenues also allow the owner-employee to service debt incurred to finance business expansion. Under either scenario, the owner-employee is unlikely to divert and commit business revenues to a retirement plan for employees during the growth and expansion stage of the business.

At some point in the development of the business, the revenues of the business will reach a level where the owner-employee perceives she has a broader range of options. I refer to this stage as having reached the "revenue threshold."³⁵⁴ The owner-employee can distribute excess revenues³⁵⁵ to herself as personal income. Alternatively, she can use excess revenues in ways that are likely to make her business continue to grow and expand in the future. If the owner-employee senses that recruiting and retaining educated and highly-skilled employees is in her long-term financial interest, she will try to make her business an attractive workplace for these types of employees. She will have to do so to be competitive on the national labor market for these types of highly sought-after workers.³⁵⁶ Competition among employers in the form of retirement benefits for these workers will require the owner-employee to "invest" part of her excess revenues in a retirement plan. In contrast, if the employees of the business are low-income workers, the owner-employee may perceive that investing in a retirement plan for these employees will not promote her financial self-interest. The owner-employee is much less likely to need a retirement plan to attract and retain these types of workers.³⁵⁷ What factors would motivate the owner-employee who does not sponsor a retirement plan to sponsor one? There is not a monolithic answer to this question. Two obvious variables would be where the business lies in the development cycle, and the level and consistency of business revenues.

Some consistent level of revenue is necessary to sustain even the administrative costs of a pure 401(k) plan having no employer contributions. Owner-employee businesses in the initial stages of growth and expansion are likely to experience fluctuations in revenues from year to year. An owner-employee whose business revenues are below the minimum threshold cannot afford a retirement plan, even if she would like to sponsor one.

A different analysis applies to an owner-employee business that is approaching, but has not yet consistently reached, the revenue threshold. Assuming the owner-employee has decided to sponsor a retirement plan once it becomes affordable, offering a tax credit for the initial start-up costs will lower the requisite revenue threshold for the first two

354. I do not attempt to assign a dollar amount to the revenue threshold because it will likely vary with both the expenses of the business and with the individual perceptions of owner-employees.

355. Rather than attempting to define the term "profit" in a financial accounting reporting sense, throughout my analysis I use the term "excess revenues" to connote available cash resources that the employer could allocate to a variety of uses, including a contribution to a retirement plan. A "profit" in the financial accounting sense is not a prerequisite to making an employer contribution to a qualified plan, even to a "profit-sharing" plan. See Rev. Rul. 66-174, 1966-1 C. B. 81.

356. See MCGILL, *supra* note 63, at 339.

357. See *supra* note 336 and accompanying text.

years of plan sponsorship. For businesses in this transitional category, the 401(k) plan is likely to be the employer's first choice as an "entry-level" retirement plan.³⁵⁸ The 401(k) plan is attractive because it does not require employer contributions to the plan. Thus the employer's costs of plan sponsorship are limited to administrative costs covered by the tax credit.

A third category of owner-employee businesses consists of businesses that have reached or perhaps surpassed the revenue threshold, but the owner-employee chooses not to sponsor a retirement plan. For this category, worker demand for a retirement plan is likely strongly to influence the owner-employee's decision.³⁵⁹ One way to stimulate employee demand is through an intensive program of sustained and broad-based public education.³⁶⁰ Such a program would emphasize the need for retirement savings to supplement Social Security benefits for a financially secure retirement. In addition, public education could reinforce the apparent moral obligation some individual owner-employees feel to provide a retirement plan for their employees.³⁶¹ Finally, smaller employers in general are unfamiliar with their options for sponsoring different types of retirement plans.³⁶² A program of public education making smaller employers more knowledgeable of the various options for retirement plans could positively impact plan sponsorship among this group.

Will these public education programs ultimately expand retirement plan coverage among low-income workers? Low-income workers in general are likely to be less educated and less knowledgeable about financial planning for retirement.³⁶³ Public education programs certainly could be designed to target low-income workers and raise their awareness of the need to save for retirement. Workers in general tend to discount the future benefits provided through a retirement plan. An effective program of public education would cause low-income workers to place a higher value on, and thus increase demand for, retirement plan benefits. Such increased knowledge and awareness may or may not translate into increased demand for retirement benefits among low-income workers. Other current financial responsibilities may make it impossible for the low-income worker to save through a 401(k) plan. For this reason, raising plan contribution and benefit limits (the traditional approach to pension reform) is unlikely to stimulate demand for retirement plan benefits among low-income workers. Low-income workers are the least able to forgo even more current income in exchange for greater retirement plan benefits. Although they may desire retirement plan benefits, they may need current income even more.

358. The empirical data indicate that the vast majority of smaller employers who choose to sponsor a retirement plan select a 401(k) plan. See 1994 FORM 5500 ANNUAL REPORTS, *supra* note 9, Table D.4 at 48; Employee Benefit Research Institute, *supra* note 12, at 6-7 (67% of small employers sponsor 401(k) plans). Oftentimes a 401(k) plan will be the only retirement plan sponsored by these employers. See 1994 FORM 5500 ANNUAL REPORTS, *supra* note 9, Table D.4 at 48.

359. See *supra* notes 351-353 and accompanying text.

360. Empirical research indicates that materials provided by the employer to educate employees on retirement savings result in higher levels of retirement savings. See *The Evolution of Retirement*, *supra* note 21, at 15. Although the Department of Labor has begun to make retirement savings information available to the public, the scope of this program is limited. See Medill, *supra* note 21, at 49-50 (criticizing the Savings Are Vital to Everyone's Retirement Act of 1997 as unlikely to promote changes in retirement savings behavior).

361. See *supra* note 349 and accompanying text.

362. See Employee Benefit Research Institute, *supra* note 12, at 8-9.

363. See Medill, *supra* note 21, at 16.

Note how the owner-employee with a "mixed" workforce of highly-skilled and low-income employees faces a dilemma. Among her pool of rank-and-file (non-highly compensated) employees, the higher paid workers demand retirement plan benefits. The low-income workers are unwilling to give up current compensation for retirement plan benefits. If the owner-employee had a sizeable workforce, under the coverage rules for qualified plans she might accommodate the interests of both groups by including the more highly paid rank-and-file workers in the plan and excluding the low-income workers from plan coverage.³⁶⁴ But many owner-employees are unlikely to have a sufficient number of employees for this strategy to be successful.³⁶⁵

How does the owner-employee solve her dilemma? She sponsors a 401(k) plan. A 401(k) plan easily satisfies the coverage rules for qualified plans. Under the coverage rules,

all of the rank-and-file employees are treated as included in the plan if they are eligible to make salary deferral contributions, even if they never do so.³⁶⁶ The higher-paid rank-and-file employees are satisfied. As non-highly compensated employees, they are not subject to the constraints of nondiscrimination testing.³⁶⁷ Therefore this group can contribute the maximum allowable amount to the 401(k) plan in the form of salary deferrals.³⁶⁸ The low-income workers too are satisfied. They choose not to make salary deferrals and receive all of their compensation as current income.

This analysis illustrates the difficulties of crafting targeted pension reform legislation in the context of the owner-employee business model. The key to enhancing the retirement income security of low-income workers in this setting is to encourage the owner-employee to move beyond an entry-level 401(k) plan to a retirement plan requiring significant employer contributions.³⁶⁹ At a minimum, the pension tax laws governing quali-

364. See discussion *supra* Part I.B.

365. See discussion *supra* Part I.B.

366. See *supra* note 56 and accompanying text.

367. See sources cited *supra* note 126.

368. See sources cited *supra* note 126.

369. Because the owner-employee business is taxed as a conduit, it may be difficult (and perhaps futile) to create tax-based incentives to encourage smaller employers to sponsor plans requiring significant employer contributions. Many owner-employees will receive a greater share of the after-tax profits of the business by taking them as personal income rather than sponsoring and contributing as an employer to a qualified plan. The example below illustrates this point using as an alternative option a basic profit sharing plan that allocates employer contributions pro rata based on compensation.

Assume the owner-employee of an S corporation takes \$1.00 of the excess revenues as personal income. At a 40% combined federal and state marginal income tax rate, he pays 40 cents in income taxes and pockets 60 cents. If he instead contributes the \$1.00 of excess revenues to a profit sharing plan, 60 cents or more will be allocated to his plan account only if his compensation is equal to or exceeds 60% of all participants in the profit sharing plan.

As the payroll of the business grows, the owner-employee's pro rata share of total compensation will shrink. By the time the business has reached a level of revenues that the owner-employee is ready to consider something more than a 401(k) plan, his proportionate share of any employer contribution to the plan will have declined. I recognize that this example could be criticized as overly simplistic. The true value for comparison purposes of the owner-employee's plan contribution should incorporate such factors as the rate of return, the value of compounding tax-deferred earnings, and the length of time the contribution will remain in the plan. The combination of these factors will increase the economic value of the owner-employer's plan contribution option vis-a-vis his after-tax alternative option for distributing business revenues. My response to such potential criticism is two-fold. First, these factors cannot be known with certainty by the owner-employee. Second,

fied plans should not operate to deter this type of transition. I argue later in Part III.C that the new pension tax policy trend of differentiating among employers on the basis of size may in fact have just such a deterrent effect.³⁷⁰

3. Closely Held Corporations

The closely held corporation model bears a superficial resemblance to the publicly traded corporation.³⁷¹ Like the publicly traded corporation model, the closely held corporation model is taxed separately.³⁷² It is usually governed by a board of directors elected by its shareholders.³⁷³ The characteristic that distinguishes between the closely held corporation model from the publicly traded corporation model, discussed previously, is that in the closely held corporation there is a substantial natural alignment of interests between majority ownership and management of the business.³⁷⁴

In the publicly traded corporation model, share ownership is widely dispersed, and shares are traded on a public market. The numerous shareholders essentially play no role in the management of the business.³⁷⁵ In contrast, the closely held corporation model assumes that there is no public market for shares of the business. Share ownership is concentrated among a discrete group who own or control at least 51% of the voting stock of the corporation ("controlling shareholders").³⁷⁶ At least some of these controlling shareholders also are employees of the business. Thus, the governance characteristics of the closely held corporation more closely resemble the owner-employee business model. Because at least some of the controlling shareholders are employees of the business, there is a stronger degree of natural incentive alignment between the top-level management employees of the business and its controlling shareholders. In addition, the closely held corporation, like the owner-employee business, is not subject to public market pressures to meet earnings expectations and distribute dividends to shareholders.

The closely held corporation model differs from the owner-employee business model in two significant respects. First, the closely held corporation model assumes there are minority owners who are not involved in the management of the business as employees ("minority shareholders"). Second, in the closely held corporation model, the corpora-

the average owner-employee is unlikely to have the time or inclination to run various scenarios based on assumed values for these factors. Instead, the owner-employee is likely to be concentrating his time and energy on operating his business. To overcome the economic disincentives to himself personally from making employer contributions to the profit sharing plan, there must exist other, more compelling business reasons for the business to sponsor something more than an entry-level 401(k) plan.

370. See discussion *infra* Part III.C.

371. See discussion *supra* Part III.B.1.

372. See sources cited *supra* note 314. The closely held corporation model assumes that the business is taxed as a C corporation and is ineligible or has not elected to be taxed as an S corporation. See *supra* note 344 and accompanying text.

373. If state corporation law permits, the board may be abolished and the corporation governed directly by its shareholders. See Del. Code Tit. 8, § 351 (1991); BALOTTI & FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS*, *supra* note 316, at § 14.7.

374. See Stabile, *supra* note 315, at 15 & n. 16 (asserting that, "In the close corporation context, the sharp distinction [between shareholders and managers] is more likely to break down because shareholders typically both own and manage the business.")

375. See sources cited *supra* note 315.

376. Under traditional state corporation law, a simple majority of the outstanding voting stock will prevail, unless the corporation's certificate of incorporation or by-laws affirmatively require a higher percentage. See Del. Code Tit. 8, § 216 (1991); BALOTTI & FINKELSTEIN, *supra* note 316, at § 7.23.

tion's profits are subject to at least two levels of tax, once to the corporation and a second time when distributed to the shareholders in the form of dividends.³⁷⁷ Under the closely held corporation model, it is this combination of double taxation and the minority shareholder presence that plays a unique role in the employer's decisions concerning retirement plan sponsorship and coverage design.

Minority shareholders exert a weak influence over business operational decisions in general, and over decisions concerning retirement plan sponsorship and coverage design in particular. American corporation law traditionally provides few rights to minority shareholders.³⁷⁸ In a publicly traded corporation, minority shareholders at least can voice their dissatisfaction with business management decisions by selling their shares on the public market, the so-called "Wall Street Walk."³⁷⁹ Activist shareholder groups can attempt to bring the interests of management into closer alignment by tying executive compensation to share value.³⁸⁰ These options are not available to the minority shareholders of a closely held corporation. There is no public market to value and sell their shares. Even if a buyer can be found for the shares, they are likely to be sold at a substantial minority interest discount.³⁸¹

The presence of the minority shareholder is keenly felt, however, when the top management employees and controlling shareholders of the business attempt to distribute excess revenues to themselves in the form of corporate dividends. If excess revenues are distributed as corporate dividends, the net amount received by the controlling shareholders will be substantially reduced, first by double taxation, and second by the pro rata share that must be paid to the minority shareholders. Example 7 below illustrates these effects, based on assumed marginal corporation and personal income tax (combined state and federal) rates of 40%, and a 25% minority shareholder interest.

Example 7

Assume the business has \$1.00 of profit that the board of directors decides to distribute as a dividend. How much of this \$1.00 will end up in the pockets of the controlling shareholders? First, the tax on corporation profits reduces the \$1.00 by 40 cents. The remaining 60 cents is distributed pro rata to all shareholders. One-fourth of the 60 cents goes to the minority shareholders, leaving 45 cents for the controlling shareholders. After paying personal income taxes at a marginal rate of 40%, the controlling shareholders net 27 cents.

Given the heavy transfer price imposed by double taxation and minority shareholder "leakage," top-level management (who in my closely held corporation model coincide with the group of controlling shareholders) may prefer to distribute excess revenues

377. See I.R.C. §§ 11, 301 (1994). A C corporation is taxed first on the profits of the business. When the profits are distributed to shareholders as dividends, the dividends are taxed a second time as personal income to the shareholders. See REPORTERS' STUDY, *supra* note 314, at 42-43.

378. See Thompson, *supra* note 320, at 1001-1003; see generally F. Hodge O'Neal and Robert B. Thompson, O'Neal's Oppression of Minority Shareholders, § 1:03 (2nd Ed. 1999).

379. See Thompson, *supra* note 320, at 1002; Chandler, *supra* note 326, at 1090.

380. See sources cited *supra* note 324.

381. See O'NEAL & THOMPSON, *supra* note 378, at § 1:03.

directly to themselves in the form of additional employee compensation.³⁸² There are both legal and practical constraints on this strategy. Legally, the Internal Revenue Service is much more likely to seek to disallow a deduction for excessive compensation in the context of a closely held corporation than in a publicly traded corporation setting.³⁸³ In addition, the courts are much more likely to entertain a challenge to executive compensation brought by a minority shareholder of a closely held corporation than of a publicly traded corporation.³⁸⁴

Paying "compensation" to top-level management in the form of benefits from a qualified plan avoids both of these constraints. Perhaps more importantly, it also eliminates the heavy transfer price of the corporate dividend alternative, as illustrated by Example 8 below:

Example 8

Assume the business contributes \$1.00 of its excess revenues to a qualified profit-sharing plan. Both the administrative costs of sponsoring the plan and the contribution amount are deductible as business expenses of the corporation. The \$1.00 is allocated to the accounts of eligible employees pro rata based on compensation. The controlling shareholders who are plan participants do not pay personal income tax on their share of the contribution until it is withdrawn from the plan. Personal income tax on investment earnings also is deferred until the funds are withdrawn from the account.

There is still leakage, but it is a different kind of leakage, in the qualified plan alternative for distributing excess revenues to the controlling shareholders. Under the non-discrimination rules, the qualified plan must cover and provide benefits to rank-and-file employees.³⁸⁵ The amount of "leakage" to rank-and-file employees, however, is reduced by designing the qualified plan to take maximum advantage of the loopholes under the

382. See *id.* at § 3:07.

383. See Melvin A. Eisenberg, *The Compensation of the Chief Executive Officer and Directors of Publicly Held Corporations*, ALI-ABA CORPORATE GOVERNANCE INSTITUTE, 127 (SE39 ALI-ABA 103, Oct. 7, 1999). The IRS may challenge the compensation as a disguised dividend, see, e.g., *O.S.C. & Assocs., Inc. v. Comm'r*, 187 F.3d 1116 (9th Cir. 1999) or as "excessive" and therefore not deductible as a reasonable and necessary business expense under Code Section 162(a), see *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833 (7th Cir. 1999). Unlike in the publicly traded corporation model, the closely held corporation cannot shield itself from an IRS challenge by obtaining shareholder approval of executive compensation under Code Section 162(m). See I.R.C. §§162(m)(1)-(2) (1994). The federal courts are divided over what test to use to determine whether executive compensation is "excessive" and therefore not deductible under Code Section 162(a). See *Exacto Spring Corp.*, *supra*. Judge Posner describes the problem of evaluating the reasonableness of executive compensation in the closely held corporation setting:

In the case of a publicly held corporation, where the salaries of the highest executives are fixed by a board of directors that those executives do not control, the danger of siphoning corporate earnings to executives in the form of salary is not acute. The danger is much greater in the case of a closely held corporation, in which ownership and management tend to coincide; unfortunately, as the opinion of the Tax Court in this case illustrates, judges are not competent to decide what business executives are worth. *Exacto Spring Corp.*, 196 F.3d at 838.

384. See Ellis, *supra* note 324, at 420; O'NEAL & THOMPSON, *supra* note 318, at § 3:08. It is more likely the threat of a potential lawsuit by the minority shareholders, rather than the probability of success on the merits, that constrains this strategy. See Thomas & Martin, *supra* note 324, at 1026, note 12 (noting that it is difficult for shareholders to succeed in a derivative action challenging a board's decision on executive compensation). But see Thompson, *supra* note 320, at 1003 (citing language of *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), that a derivative suit is a "potent tool" to redress the conduct of management).

385. See I.R.C. §§ 410(b); 401(a)(4) (1994).

coverage rules of Code Section 410(b).³⁸⁶

Note that even the "leakage" portion of the employer's contribution to the qualified plan has the potential for longer term benefits for the controlling shareholders that are not present under the corporate dividend option. Employee morale and productivity may be enhanced by participation in the plan. Any resulting increases in the revenues and profits of the business can inure to the benefit of the controlling shareholders in the form of higher employee compensation. This higher compensation will be less susceptible to claims of unreasonableness or excessiveness by both the Internal Revenue Service and minority shareholders.³⁸⁷

As the above discussion illustrates, the closely held corporation model is unique because closely held corporations can use retirement plans as a mechanism to direct excess revenues of the business to controlling shareholders. Closely held corporations are not unique, however, in that they are subject to the same employee recruitment and retention competitive pressures as publicly traded corporations and owner-employee businesses.³⁸⁸ To compete for educated and highly skilled workers, closely held corporations must offer retirement plan benefits.³⁸⁹ When a closely held corporation competes against publicly traded corporations for these types of workers, generous retirement benefits become even more important. Closely held corporations cannot match the incentives based on publicly traded stock offered by publicly traded corporations.³⁹⁰ Offering more generous retirement plan benefits is one way for the closely held corporation to overcome this disadvantage.

C. Implications for Lawmakers

The targeted reform theory presents a useful analytical tool for lawmakers to evaluate the likely effectiveness of proposed legislation in achieving targeted pension reform.

386. See discussion *supra* Part I.B. "Leakage" to the rank-and-file employees can be further minimized if the employer takes maximum advantage of the rules available under Code Section 401(a)(4), such as integration and so-called "new comparability" plans. See Dilley, *supra* note 7, at 1171-79 (discussing integration); IRS Notice 2000-14, 2000-10 I.R.B. 737 (Feb. 24, 2000) (describing Internal Revenue Service concerns over new comparability plans); MCGILL, *supra* note 63, at 79-83 (describing operation of the general test for compliance with Code Section 401(a)(4)). Such loopholes, used to shift more of the benefits of the qualified plan to the highly compensated employees, certainly must be addressed as part of comprehensive legislative agenda designed to achieve targeted pension reform. See discussion *infra* Part IV.C. The complex regulations that implement Code Section 401(a)(4), and how pension tax law experts can manipulate these rules to allocate a greater level of benefits to highly compensated employees, is beyond the scope of this article. The Internal Revenue Service is well-aware of how these rules are used in practice, and is in the process of developing regulations to curtail abuses. See Bonner Menking, *Officials Present Guidance Update, Review "New Compatibility" Regs.*, 89 TAX NOTES 341-342.

387. Under federal tax caselaw, the "reasonableness" of executive compensation for purposes of Code Section 162(a) is determined by a multiple-factor test that considers, among other factors, the net earnings of the employer, the levels of executive compensation paid by companies of similar size, revenues, and profits, and the rate of investor return. See *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833 (7th Cir. 1999); *O.S.C. & Assocs., Inc. v. Comm'r*, 187 F.3d 1116 (9th Cir. 1999). Claims by minority shareholders of excessive compensation paid to controlling shareholders are resolved under principles of state corporation law. See, e.g., *Crowley v. Communications for Hospitals*, 30 Mass. App. Ct. 751, 573 N.E.2d 996 (1991).

388. See MCGILL, *supra* note 333.

389. See *id.*

390. See sources cited *supra* note 329.

Applying the targeted reform theory to current legislative proposals reveals that, if enacted, these proposals are likely to be ineffective or, even worse, counterproductive to the expansion of retirement plan coverage.

1. More Rules Based on Employer Size Will Not Significantly Expand Coverage

The targeted reform theory predicts that creating separate sets of qualified plan rules based on the number of employees will not significantly expand the scope of retirement plan coverage. The employer's decision-making process for plan sponsorship and coverage design is a function of its governance and taxation characteristics. Employer size is only a rough surrogate for these factors. Therefore, creating special sets of qualified plan rules based on employer size is unlikely to stimulate new plan sponsorship among smaller employers.

The proposed SAFE plan is unlikely to inspire owner-employee businesses to sponsor new defined benefit plans. Employee demand for defined benefit plans is low. The revenue commitment to funding and investment risk for the owner-employee is high. Simplified administration alone will not overcome these deterrents.

In contrast, SIMPLE plans for smaller employers avoid these disadvantages of SAFE plans. In the longer-term, however, SIMPLE plans pose two potential obstacles to the owner-employee's transition from an entry-level 401(k) plan to a plan funded by employer contributions. First, the revenue threshold for a plan requiring significant employer contributions is obviously much higher than for a 401(k) plan funded solely by the workers themselves. To reach this higher revenue threshold the business will need to further grow and expand. Growth in excess of the arbitrary 100 employee threshold will force the employer to terminate or amend the SIMPLE plan to conform to the rules for 401(k) plans.

Second, assuming the employer can reach the higher revenue threshold without exceeding the 100-employee limit, the employer cannot maintain the SIMPLE plan if it sponsors any other retirement plan (other than a defined benefit SAFE plan, an unattractive option). Before the employer may add a retirement plan funded by employer contributions (the most likely choice being a profit sharing plan), it must either terminate the SIMPLE plan or amend its design to comply with the rules for 401(k) plans. Thus the SIMPLE plan approach creates a disincentive for the smaller employer to make this key transition beyond the employee-funded 401(k) plan.

A broader policy concern is that creating multiple sets of plan design rules based on employer size only adds to the complexity of the overall pension tax law system.³⁹¹ Perhaps this additional systemic complexity perhaps could be justified if it were likely to result in a significant expansion of pension plan coverage among smaller employers. But the empirical research demonstrates that plan administrative costs are not a decisive factor in the smaller employer's decision to sponsor a retirement plan.³⁹²

2. Higher IRA and 401(k) Contributions Limits Are Counterproductive

The targeted reform model predicts that higher limits for contributions to IRAs will

391. See sources cited *supra* note 113 and accompanying text.

392. See *supra* notes 351-353 and accompanying text.

be counterproductive to the goals of targeted pension reform because such higher limits will decrease worker demand for employer-sponsored retirement plans. Similarly, higher limits for 401(k) plan contributions will decrease worker demand for a retirement plan funded by employer contributions. The likely result of these proposed legislative changes will be to slow, not stimulate, the growth of new plan sponsorship for 401(k) plans and employer-funded retirement plans. In addition, higher 401(k) plan contribution limits will increase the distributional inequities in the pension tax law system without improving the retirement income security of low-income workers.

3. *Requiring Broader Coverage Will Not Trigger Plan Terminations or Deter New Plans*

Another significant insight provided by the targeted reform theory is that the governance characteristics of publicly traded and closely held corporations provide strong incentives for them to exclude as many workers from retirement plan coverage as is legally permissible under the coverage rules. The targeted reform theory demonstrates why, absent government compulsion, these employers are unlikely to voluntarily expand the scope of pension coverage. Because plan sponsorship is voluntary, the perceived danger in amending the coverage rules has always been that employers will refuse to adopt retirement plans or, worse yet, decide to terminate their existing retirement plans.³⁹³

The typical public political debate over broadening the coverage rules for qualified plans to make retirement plans more inclusive is like a game of chicken. Reforms to make the coverage rules more inclusive are proposed. Employers counter with the dramatic threat that they will terminate their plans rather than suffer the increased costs of expanded coverage. But the threat cannot be selective - the plan is an all-or-nothing proposition for the employer.

Given today's robust economy and tight labor market, legislation that closes the coverage loopholes in the pension tax laws is unlikely to trigger a counterproductive backlash of plan terminations by employers. For both the publicly traded and closely held corporation models, the impact of terminating a pre-existing retirement plan in response to more inclusive coverage rules would have a dramatic effect on their workforce, and, consequently, on business profitability. Such a reaction would immediately put the employer at a distinct competitive disadvantage in recruiting and retaining the educated and highly skilled workers who are critical to the continued viability of the business. In addition, for closely held corporations the motivation to sponsor a retirement plan includes

393. See Halperin, *supra* note 9, at 5-6. Proponents of this view are likely to point for support to the large number of defined benefit plans that were terminated during the deficit cycle years after the TAX REFORM Act of 1986 tightened the coverage rules for qualified plans. See PENSION AND WELFARE BENEFITS ADMINISTRATION, U.S. DEPT. OF LABOR, PRIVATE PENSION PLAN BULLETIN No. 6, ABSTRACT OF 1993 FORM 5500 ANNUAL REPORTS (Winter 1997), Table F1 at 73. Most of these terminations, however, were by smaller employers who sponsored defined benefit plans with fewer than 100 participants. See *id.* at 2, table F2 at 74. I would argue that it was not tighter coverage rules, but rather the changes to the full funding limits for defined benefit plans enacted by the Omnibus Budget Reconciliation Act of 1987, that was primarily responsible for the mass termination of defined benefit plans by small employers in the following years. See *Stretching the Pension Dollar*, *supra* note 40, at 3-7.

providing additional compensation to the controlling shareholder-employees. Terminating an established retirement plan would be counterproductive to this objective. Moreover, for those closely held corporations that are family-owned, terminating the company's retirement plan could present a significant obstacle to the eventual transfer of the business to younger generations. Without a plan to provide income during retirement, the older generation of controlling shareholders may be forced to sell the business to outside investors to fund their retirement years.

For some employers, including more employees in their pre-existing retirement plan may prove too costly due to the benefit structure of the plan. If this is the case, the employer has a much less drastic option available than terminating the plan. The employer can simply amend the plan benefit design so that it becomes affordable.³⁹⁴ Does this mean that some participants in the plan are likely to receive a lower level of retirement benefits? Certainly. But this is exactly the type of policy trade-off that should be, but currently is not, the subject of open and vigorous legislative and public debate.

Amending the coverage rules to make them more inclusive also is unlikely to deter the sponsorship of new retirement plans by employers. Most established businesses already sponsor retirement plans.³⁹⁵ It is newer and smaller employers, represented by the owner-employee model, who are the most likely not to sponsor any type of retirement plan for their employees.³⁹⁶ Amending the coverage rules to make retirement plans more inclusive is unlikely to deter these employers from sponsoring a new retirement plan. Due to their relatively small numbers of employees, these businesses are the least able to utilize the provisions in the plan coverage rules that larger employers use to exclude certain groups of workers from retirement plan coverage.³⁹⁷ Instead, employee demand for retirement plan benefits is the driving force behind the employer's decision to sponsor a retirement plan.

V. GENERAL PRINCIPLES FOR TARGETED PENSION REFORM LEGISLATION

For reform to be sustainable in the long term, amendments to the pension tax laws should attempt to minimize the cyclical effect of the budget balancing process on pension tax policy and thus minimize the instability and uncertainty in the system. This can be done in two general ways: (1) by developing legislation that strategically targets the pension tax expenditure toward broadening the coverage base rather than increasing the tax-subsidized retirement benefits available to highly compensated employees; and (2) by focusing legislative attention on obstacles to and incentives for new plan sponsorship that are the least susceptible to budgetary cycles.

394. This option is likely to be much more appealing to the sponsoring employer than terminating the plan. Legally, plan amendment is a much more simple affair than plan termination. From a practical perspective, a plan amendment to reduce the level of future benefits will have a much less dramatic effect on the employer's ability to recruit new employees. Potential employees obviously can distinguish between an employer with no retirement plan and an employer who has a retirement plan. It is much more difficult, however, for a potential employee to evaluate the "quality" of benefits under competing retirement plans offered by prospective employers.

395. See discussion *supra* Part I.A.

396. See *supra* Table 1 (Coverage Rates by Occupation), note 19 and accompanying text.

397. See discussion *supra* Part I.B.2.

A. Targeted Pension Reform Legislation to Broaden the Coverage Base

The traditional approach to pension reform attempts to encourage, but not compel, employers to broaden the scope of retirement plan coverage by substantially increasing the limitations rules for qualified plans.³⁹⁸ The targeted reform theory demonstrates why this approach is unlikely to produce significant gains in the scope of pension coverage.³⁹⁹ A targeted reform approach to broadening the coverage base instead would amend the coverage and eligibility rules governing qualified plans to require more comprehensive coverage of the employer's workforce.⁴⁰⁰ This approach would result in retirement plan coverage for more rank-and-file employees. Making the coverage and eligibility rules more inclusive will certainly increase the aggregate pension tax expenditure because more workers will benefit from the pension tax subsidy. But, contrary to current proposals to reform the pension tax laws, this increase in the overall pension tax expenditure would result in a more equitable pension tax law system. Targeted pension reform would primarily benefit low-income workers who are in lower income brackets. In contrast, current reform proposals would primarily benefit highly compensated employees who are in higher income tax brackets, thereby making the pension tax law system as a whole less equitable.

1. Amending the Coverage Rules

The coverage rules of Code Section 410(b) have remained unchanged since the Tax Reform Act of 1986.⁴⁰¹ An obvious first step would be to increase the percentage of non-highly compensated employees required to be covered by the plan.⁴⁰² This could be done by repealing the ratio percentage prong of current Code Section 410(b)(1)(B).⁴⁰³ Qualified plan coverage should be determined by requiring that a straightforward percentage of the employer's non-highly compensated employees must be included in the plan.

What should the appropriate percentage be? One scholar has suggested a 100% coverage rule for non-highly compensated employees.⁴⁰⁴ Requiring a 100% coverage rate for non-highly compensated employees, however, may prove to be politically impractical.⁴⁰⁵ I propose an incremental approach to reforming the ratio percentage test by phasing in higher standards over a period of years, with a final goal of required coverage in the 90% range. A variation of this approach (and one conducive to political compromise) would be to link higher limitations rules amounts for highly compensated employees to higher plan coverage percentages for the non-highly compensated employees, again based on a straightforward percentage of non-highly compensated employees covered test.

As second and third steps toward broadening the coverage base, Congress should

398. See *supra* Part II.A.1.

399. See *supra* Part III.B.

400. See *supra* Part I.B.1-2.

401. See *supra* Part I.B.2.

402. See *supra* Part I.B.2.

403. See discussion *supra* Part I.B.2.

404. See Halperin, *supra* note 9, at 38-39.

405. See Muir, *supra* note 25, at 213-15.

consider repealing the average benefits test, and reform the SLOB rules to require a showing of competitive necessity.⁴⁰⁶ Although the number of employers that rely on these tests to satisfy the coverage rules for qualified plans is relatively small, those employers who use these rules are likely to vigorously oppose their repeal or reform. Congressional lawmakers will have to make an informed policy judgment concerning the estimated coverage gains to be made by repealing or reforming these provisions of the coverage rules.

2. Amending the Eligibility Rules

Given the high degree of mobility of today's workforce, it seems absurd to continue with eligibility rules that have remained unchanged since the enactment of ERISA in 1974.⁴⁰⁷ As a first step toward modernizing the eligibility rules, the one year of service rule should be repealed for 401(k) plans. All employees should be immediately eligible to begin participating in their new employer's 401(k) plan.⁴⁰⁸ Although immediate eligibility is likely to increase the administrative costs of the 401(k) plan for employers with high levels of employee turnover, these increased costs can be offset by enacting other proposals to simplify the administration of qualified plans.⁴⁰⁹

Second, Congress should modernize the eligibility rules for non-401(k) plans by shortening the one year of service rule for eligibility. Amending the eligibility rules for non-401(k) retirement plans will likely be strongly opposed by employers. Shortening the year of service rule for these plans will require the employer to more quickly make contributions to the plan for new employees. Although employers are unlikely to respond by terminating their retirement plans, they may choose to offset any increased costs by amending the plan to reduce the level of benefits for all participants. Thus, the policy "price" for increasing the scope of retirement plan coverage for some low-income employees may be a slightly lower level of benefits for all employees of the employer. Clearly, the political battle over such a proposal to reform the eligibility rules for non-401(k) plans will be intense. The purpose of this article is not to conclusively resolve the controversy, but rather to introduce competing ideas for reform to make these types of important policy trade-offs the subject of open and vigorous legislative and public debate.

3. Amending the Vesting Rules

Like the eligibility rules, today's vesting requirements for qualified plans have become outdated. Under current law, the employer may choose between a vesting schedule where partial vesting begins at three years, gradually increasing to full vesting at seven years,⁴¹⁰ or a vesting schedule where the employee is not vested until five years, at

406. See *supra* Part I.B.2.

407. See *supra* Part I.B.1.

408. Congress has already moved to encourage employers to adopt immediate eligibility for 401(k) plan participation by exempting first year participants from inclusion in the plan's ADP test. See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1459, 110 Stat. 1755, 1820.

409. See discussion *infra* Part IV.B.

410. See I.R.C. § 411(a)(2)(B) (1994 & Supp. IV 1998).

which time he becomes fully vested.⁴¹¹ Under either type of vesting schedule, the new employee will not become even partially vested until the employee completes at least three years of service. Consequently, the vesting rules pose a serious obstacle to achieving retirement income security for today's mobile workers. To achieve targeted pension reform, it will not be enough for Congress to amend the coverage and eligibility rules for qualified plans. A less lengthy vesting schedule should be included as part of a comprehensive legislative package aimed at targeted pension reform.

B. Addressing Non-Revenue Obstacles and Incentives to New Plan Sponsorship

The targeted pension reform proposals described above primarily are directed toward expanding the scope of coverage among employers who already sponsor a retirement plan for their employees, but who exclude low-income workers from participating in the plan. The other group of workers who tend to lack pension coverage are employees who work for an employer who does not sponsor any type of retirement plan for its employees. This section focuses on targeted reforms that will expand the scope of pension coverage by encouraging employees to sponsor new retirement plans.

1. Administrative Simplification

A close examination of current proposals to simplify the administration of qualified plans reveals that such proposals can be divided into two groups. One group of proposals truly simplifies plan administration. The other group of proposals masquerade under the rubric of simplification, but actually serve to redistribute a larger share of the pension tax subsidy to higher-income employees. The line between the two is easy to divine. Proposals to amend the rules for direct rollovers, required minimum distributions, reporting requirements, and compliance correction programs⁴¹² are aimed at true simplification. These measures are projected to have a negligible revenue effect.⁴¹³ Although administrative costs are not the primary deterrent to new plan sponsorship among employers,⁴¹⁴ enacting reform legislation aimed at true administrative simplification can only help in achieving higher levels of plan sponsorship.

Proposals to amend the top-heavy rules and reduce the level of employer contributions necessary to exempt 401(k) plans from ADP testing are disguised efforts to redistribute a larger share of the pension tax subsidy to higher-income employees.⁴¹⁵ The empirical evidence indicates that the tax benefits to these employees are not a primary motivating factor in the employer's decision to sponsor a new retirement plan.⁴¹⁶ These proposals should be rejected by lawmakers committed to targeted pension reform. They will only serve to increase the distributional inequities in the pension tax law system without expanding the scope of retirement plan coverage.

411. See I.R.C. § 411(a)(2)(A) (1994 & Supp. IV 1998).

412. See *supra* Part III.A.4.

413. See *supra* note 205 and accompanying text.

414. See *supra* Part III.B.2.

415. See *supra* Parts I.B.C. and III.A.4.

416. See *supra* Part III.B.2.

2. Promoting a More Efficient Market for Plan Administrative Services

Current proposed legislation focuses on stimulating new plan sponsorship by providing one-time tax credits for smaller employers who initiate a retirement plan.⁴¹⁷ A complementary, but longer lasting, approach to encouraging plan sponsorship would be to reduce the plan administrative costs for all employers by promoting a more efficient market for plan administrative services.

The Department of Labor's own study of the fees charged by plan service providers for administering 401(k) plans indicates that there is not a competitive market for plan administrative services.⁴¹⁸ Smaller employers, in particular, are harmed by the uncompetitive market for plan administrative services because their options for service providers tend to be limited to their local geographic market. The small number of participants in the plan may not meet the minimum number of plan participants required by larger national service providers. One way to make the market for plan administrative services more competitive would be to facilitate the smaller employer's ability to compare the fees and services offered by different service providers. Proposed legislation could facilitate this information-gathering process by requiring the Department of Labor to maintain a voluntary registry or on-line database of plan service providers, their fees and services, and how to contact them.⁴¹⁹

3. Stimulate Employee Demand Through Effective Public Education

One of the primary factors motivating an employer to sponsor a new retirement plan is employee demand for retirement benefits. Congress should require, and adequately fund, a *sustained and aggressive* program of broad-based public education concerning the need to plan and save for retirement.⁴²⁰ Public education programs should particularly focus on low-income workers and younger workers. For both groups the emphasis should be not on the immediate income tax savings from 401(k) plan salary deferrals (likely to be a low priority for these groups of workers), but rather on the economic magic of earning a pre-tax rate of investment return over a long period of time.⁴²¹

VI. CONCLUSION: COMPLETING THE TARGETED PENSION REFORM AGENDA

The proposals described in Part IV are initial steps toward achieving the goals of targeted pension reform. But other (and much more technical) loopholes in the pension tax law system remain. The most prominent of these loopholes are the rules governing contingent workers⁴²² and the complex rules governing the distribution of plan benefits

417. See *supra* Part II.A.3.

418. See PENSION AND WELFARE BENEFITS ADMINISTRATION, STUDY OF 401(K) PLAN FEES AND EXPENSES, Section IV, April 13, 1998, (visited Oct. 3, 2000) <<http://www.dol.gov/dol/pwba>>.

419. For an example of what such a database might look like, see Mandelker, *supra* note 41, at 91-96.

420. Congress previously legislated a public education program under the auspices of the Department of Labor in the Savings Are Vital to Everyone's Retirement Act of 1997 (SAVER). I discuss the SAVER public education initiative elsewhere and argue that it is unlikely to be effective in changing retirement savings behavior. See Medill, *supra* note 21, at 49-50.

421. See *supra* note 229 and accompanying text.

422. See *supra* note 26. Contingent workers are further subdivided into leased employees and independent contractors. Code Section 414(n) governs the treatment of leased employees. See I.R.C. § 414(n) (1994 &

under Code Section 401(a)(4).⁴²³ The abuse of these rules by employers is well-known to government regulators.⁴²⁴ Reform of these rules will be necessary to complete a comprehensive legislative agenda aimed at targeted pension reform.

Requiring employers to broaden the scope of retirement plan coverage without also addressing these additional rules is akin to placing a large rock in an even larger stream—the flow of pension money will simply be redirected via these complex loopholes. Employers are likely to react to more inclusive coverage rules by taking advantage of the contingent worker rules and re-characterizing their workers as leased employees or independent contractors. Employers also are likely to react to expanded coverage by using Code Section 401(a)(4) rules to redesign retirement plans to distribute a greater share of benefits to highly compensated employees. For targeted pension reform to be successful, Congressional lawmakers must anticipate these types of reactions by employers, and reform additional rules accordingly.

The purpose of this article is less ambitious. This article shows why targeted pension reform is needed, and argues that such reform can be achieved without undermining the voluntary nature of our private retirement plan system. Reforming the pension tax system should be a national priority. Today, Congress has an historic opportunity to change the course of national retirement policy. They can choose to target the pension tax subsidy for the greater benefit of workers who are most at risk of having an inadequate retirement income. This article lays the basis for a legislative agenda involving precisely that sort of targeted pension reform.

Supp. IV 1998). The classification of workers as independent contractors rather than employees is governed by a 20-factor test. See IRS Rev. Rul. 87-41.

423. I.R.C. § 401(a)(4) (1994).

424. See, e.g., Pensions: Letters Reveal Split In Pension Industry Over "Comparability" Cross-Testing Methods, DAILY TAX REP. J-1 (June 13, 2000) (discussing Code Section 401(a)(4)); Jacob M. Schlesinger and Eben Shapiro, U.S. Challenges Time Warner on Benefits, WALL ST. J., Oct. 27, 1998, at B20.