

10-1-1983

A Perspective of the Qualified Plan Tax Subsidy

Michael A. Oberst

University of Florida School of Law

Follow this and additional works at: <https://digitalcommons.law.buffalo.edu/buffalolawreview>



Part of the [Retirement Security Law Commons](#)

Recommended Citation

Michael A. Oberst, *A Perspective of the Qualified Plan Tax Subsidy*, 32 Buff. L. Rev. 603 (1983).

Available at: <https://digitalcommons.law.buffalo.edu/buffalolawreview/vol32/iss3/3>

This Article is brought to you for free and open access by the Law Journals at Digital Commons @ University at Buffalo School of Law. It has been accepted for inclusion in Buffalo Law Review by an authorized editor of Digital Commons @ University at Buffalo School of Law. For more information, please contact lawscholar@buffalo.edu.

A PERSPECTIVE OF THE QUALIFIED PLAN TAX SUBSIDY

MICHAEL A. OBERST*

INTRODUCTION

As is the case with most industrialized nations, the United States government wants its citizens to be provided with adequate subsistence during their retirement years. Since the enactment of the Social Security Act of 1935, most retired and disabled Americans have been able to depend upon Federal Old-Age, Survivors, and Disability Insurance—"social security"—as the foundational source of this subsistence. As social security provides only minimal retirement benefits, it has become necessary to supplement these benefits from other sources. Approximately 50% of the American private sector work force looks to employer established "qualified plans" as the necessary retirement income supplement to social security.¹

In contrast to "nonqualified plans,"² qualified plans are subject to a seemingly infinite battery of requirements set forth in the Internal Revenue Code³ and the regulations and rulings of the Internal Revenue Service (IRS). Compliance with these requirements brings some major tax concessions into play. Thus, while the employer gets a deduction for contributions to the qualified plan trust,⁴ neither the trust nor its employee-beneficiaries are immediately subject to income tax with respect to the contributions and

*Associate Professor of Law, University of Florida School of Law; B.S.B.A., University of Florida, 1963; J.D., University of Florida, 1968. The author was formerly Legislation Counsel, Staff of the Joint Committee on Taxation.

1. PRESIDENT'S COMM'N ON PENSION POLICY, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY 34-40 (1981).

2. Essentially, a nonqualified plan is any plan deferring the receipt of compensation which does not meet the qualified plan requirements. The tax treatment of nonqualified plans is discussed in an ensuing section (describing the "Special Tax Treatment of Qualified Plans").

3. See I.R.C. §§ 401-418E (1982). Unless otherwise noted, all section references are to the Internal Revenue Code of 1954, as amended through the 1982 edition.

4. *Id.* § 404(a). The employer will not receive a § 162 or a § 212 deduction, but if a plan satisfies the conditions of either, the employer will receive a § 404(a) deduction subject to limitations on amounts deductible described in § 404(a)(1)-(9).

earnings thereon;⁵ taxation is deferred until the time that the trust distributes benefits to the employee.⁶ As will be explained, this deferral of taxation represents an ever-increasing subsidy by our government of the qualified plan system.

The qualified plan dates back to 1921,⁷ but, with the exception of some significant reforms in 1938⁸ and 1942,⁹ was not the subject of any comprehensive legislation until 1974 when the Employee Retirement Income Security Act (ERISA)¹⁰ was enacted. Subsequently, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)¹¹ made a number of further significant changes in the qualified plan provisions.

Both ERISA and TEFRA address major issues as to the allocation of the private pension tax subsidy: To what extent should this subsidy be allocated to high-income individuals? More specifically, what limits should be placed upon the contributions to, or benefits derived from, tax subsidized qualified plans? To what extent should the qualified plan system provide for the retirement income needs of low- and middle-income individuals? More specifically, to what extent, if any, should an employer's contributions to the social security system reduce its obligation to contribute to a qualified plan? The purpose of this Article is to discuss whether Congress has effectively resolved these fundamental issues.

Section I of this Article will provide a basic explanation of the qualified plan rules¹² and policies. Section II discusses the merit of

5. *Id.* §§ 402(a)(1), 501(a). The distributed amount is taxable under § 72 (relating to annuities) in the year in which so distributed.

6. *Id.* § 402(a)(1).

7. Revenue Act of 1921, ch. 136, § 219(f), 42 Stat. 247.

8. In the Revenue Act of 1938, ch. 289, § 165(a)(2), 52 Stat. 518 (current version at I.R.C. § 401(a)(2)), Congress articulated for the first time that the corpus or income of a qualified plan trust must be devoted exclusively to the benefit of the employee-beneficiaries.

9. In the Revenue Act of 1942, ch. 619, § 162(a), 56 Stat. 862 (current version at I.R.C. §§ 401(a)(4), 410(b)), Congress established standards to prevent discrimination in both employee coverage and allocation of benefits and contributions.

10. Employee Retirement Income Security Act [ERISA] of 1974, Pub. L. No. 93-406, 88 Stat. 829.

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

12. This Article is not intended to be a discourse on the technicalities of the qualified plan provisions. Its purpose is to explore several fundamental issues pertaining to the merit of qualified plans as they are presently structured. Consequently, every attempt will be made to avoid getting sidetracked in the labyrinth of rules that comprise this overweight body of law.

the current limits on contributions and benefits. Section III discusses the merit of the current "integration" rules. This discussion leads to the ultimate conclusion that the present and ever-increasing qualified plan tax subsidy is wasteful because too much of it is allocated to high-income individuals who do not need it, and too little is allocated to middle- and, particularly, low-income individuals who do need it. In order to attain a more rational and humane allocation of this subsidy, this Article calls for the elimination of integration and the reduction of the contribution and benefit limits to middle-income levels. These changes would cause some employers to terminate their qualified plans. For those rank and file who lose coverage as a result of these terminations, and, more significantly, for the massive number of rank and file who have never been covered, this Article introduces the only practical solution: a minimum mandatory contribution system.

I. DESCRIPTION OF THE QUALIFIED PLAN

This Section will describe first the disparate methods of funding retirement benefits that fall under the umbrella classification, "qualified plan." An overview will then be provided of the various rules that must be obeyed in order for a plan to attain "qualified" status. The overview will be followed by a description of the special tax benefits that accrue to a qualified plan and its participants. The final part of this Section will discuss the policies underlying the qualified plan provisions.

A. *Types of Qualified Plans*

There are two basic types of qualified plans: the "defined contribution plan" and the "defined benefit plan." Both of these plans commonly are embodied in a trust¹³ which serves as the recipient and investor of contributions. These contributions plus the earnings thereon will ultimately be distributed as retirement benefits.

1. *Defined Benefit Plans.* A defined benefit plan provides a specified benefit to be paid annually after the participant retires.¹⁴ Thus, for example, a defined benefit plan might specify an annual

13. Instead of a trust, an employer may make deductible payments to an insurance company towards the purchase of retirement annuities for its employees. I.R.C. § 404(a)(2).

14. Treas. Reg. § 1.401-1(b)(1)(i). Unless otherwise noted, all references to regulation sections are to those in effect in 1983.

retirement benefit until death equal to 2% of the participant's average compensation multiplied by the number of years of service the employee has given to the employer.¹⁵ With each "year of service,"¹⁶ a participant in a defined benefit plan accrues a portion of a promised annual retirement benefit.¹⁷

In almost all cases, an actuary must be employed to estimate the contributions that will be necessary to fund the defined benefit plan's promised benefits. These computations necessarily involve such assumptions as the earnings rate on trust investments, the turnover rate of employees who leave the company's employ before fully vesting in their otherwise earned benefits, and the life expectancies of retiring participants. The risk of poor investment performance falls upon the employer who ultimately must provide enough funds at the time of retirement to deliver the promised benefit. Since ERISA, most defined benefit plans have been subject to a governmentally administered compulsory insurance program which guarantees, within prescribed limits, the payment of previously vested benefits in the event of plan termination.¹⁸

2. *Defined Contribution Plans.* In contrast to a defined benefit plan, a defined contribution plan makes no promises as to a specified retirement benefit. Each participant's retirement "nest egg" is represented by an account which reflects the participant's share of the aggregate amount of contributions and trust earnings and losses.¹⁹ Thus, the participant in a defined contribution plan must bear the burden of the trust's inadequate investment performance. Of course, successful trust investment performance directly benefits the participant.

There are three main varieties of defined contribution plans: the "money purchase pension plan," the "profit sharing plan," and

15. Under this example, a retiring employee with average compensation of \$40,000 and 25 years of service would be entitled to an annual retirement benefit of \$20,000 (2% × \$40,000 × 25).

16. Generally, a "year of service" is a designated 12-month period during which an employee performs at least 1000 hours of service. I.R.C. § 411(a)(5)(A).

17. Alternative accrual rules are set forth under I.R.C. § 411(b)(1).

18. For a comprehensive discussion of this insurance program, see M. CANAN, *QUALIFIED RETIREMENT PLANS* 459-500 (1977).

19. In two types of defined contribution plans, the "profit sharing plan" and the "stock bonus plan," forfeitures of terminated employees' unvested account balances are reallocated among, and increase, the accounts of the remaining participants. In other plans, forfeitures may be used only to reduce future employer contributions. I.R.C. § 401(a)(8).

the "stock bonus plan." The amount of the contribution to a money purchase pension plan is determined and obligatorily made pursuant to a formula set forth in the plan instrument.²⁰ In contrast, the amount of the annual contribution to a profit sharing plan may be determined according to the employer's discretion, but it may not exceed the amount of the employer's profits.²¹ Thus, for a particular year, an employer may decide to make a contribution to its profit sharing plan equal to 10% of its net profits for the year. While the contributions to a profit sharing plan may be made on a discretionary basis, the allocation of those contributions to the participants' accounts must be made pursuant to a predetermined plan formula.²² A stock bonus plan, which itself has some subvarieties,²³ is similar to a profit sharing plan except that the amount of the contribution is not limited by profits and the plan is funded primarily with the stock of the employer corporation.²⁴

B. *An Overview of the Qualified Plan Requirements*

In order to be accorded favorable qualified plan treatment, a plan must meet a number of requirements which are set forth in the Internal Revenue Code,²⁵ its concomitant regulations, and IRS rulings. Principal among the qualified plan requirements are those that forbid "discrimination" in favor of the "prohibited group" in terms of both the scope of employee coverage²⁶ and the allocation

20. Treas. Reg. § 1.401-1(b)(1)(i). In the case of money purchase pension plans, employer contributions are fixed without being geared to profits.

21. *Id.* § 1.401-1(b)(1)(ii). In addition, profit sharing plans must not discriminate in operation to favor certain types of employees. *See id.* § 1.401-3, -4; *see also infra* note 26 and accompanying text (discussing "prohibited groups").

22. Treas. Reg. § 1.401-1(b)(ii).

23. One subvariation is the so-called "leveraged employee stock ownership plan" ("leveraged ESOP"). *See* I.R.C. § 4975(d)(3), (e)(7). A leveraged ESOP borrows money from a third party in order to acquire employer stock. Subsequently, the deductible contributions made by the employer to the leveraged ESOP are used to pay off the third-party loan.

Another subvariation is the so-called "tax credit employee stock ownership plan" ("tax credit ESOP"). *See* I.R.C. § 409A. If certain conditions are met, an employer is allowed a special income tax credit for contributions (primarily of employer stock) to a tax credit ESOP. The credit is limited to a prescribed percentage of the aggregate compensation of all employees covered by the plan. *Id.* § 44G(a)(2). For a comprehensive discussion of these plans, *see* Kaplan & Ludwig, *ESOPs*, 354 *Tax Mgmt.* 2d (BNA) at A-1 (1983).

24. Treas. Reg. § 1.401-1(b)(1)(iii).

25. *See* I.R.C. §§ 401-418E.

26. *Id.* § 410(b)(1).

of contributions and benefits among covered employees.²⁷ The "prohibited group" is comprised of certain employees who may be stockholders, officers, or those with high earnings from the rendition of personal services.²⁸ In terms of the scope of the plan's coverage of employees, the anti-discrimination test is satisfied if 56% or more of the company's employees are covered by the plan, regardless of the composition—"prohibited group" compared to rank and file—of the employee group that is covered.²⁹ Even if this mathematical test is not met, the IRS may still determine that the composition of the covered group does not result in the proscribed discrimination.³⁰ Under this subjective test, the IRS has approved a plan covering 27% of all employees, 55% of those covered belonging to the prohibited group.³¹

Discrimination is also prohibited vis-a-vis contributions to defined contribution plans and benefits provided by defined benefit plans.³² This discrimination test is met if the percentage of "total compensation"³³ that is represented by contributions or benefits is at least as high for the rank and file as it is for the prohibited group.³⁴ For example, this discrimination test would allow contributions to a defined contribution plan which were allocated to each account in amounts equaling 15% of each participant's total compensation. These contributions would be allowed because they represent the same proportion (15%) of both groups' total compen-

27. *Id.* § 401(a)(4).

28. *Id.* §§ 401(a)(4), 410(b)(1)(B).

29. *Id.* § 410(b)(1)(A). Under this provision, the anti-discrimination test is met if at least 70% of the employees are eligible for coverage and 80% of those eligible are, in fact, covered. *Id.* Alternatively, the test is satisfied if at least 70% of the employees are covered. *Id.*

30. *Id.* § 410(b)(1)(B).

31. Rev. Rul. 83-58, 1983-1 C.B. 95. On the other hand, discrimination has been found to exist when 42% of all employees were covered, but 83% of those covered were in the prohibited group. *Commissioner v. Pepsi-Cola Niagara Bottling Corp.*, 399 F.2d 390 (2d Cir. 1968).

32. An employee must commence participation in the plan within six months of his satisfaction of certain minimum age and service requirements. I.R.C. § 410(a)(4)(B). However, if the first day of the next plan year occurs during that six-month period, participation must begin on that day. *Id.* § 410(a)(4)(A). In most cases, the minimum age and service requirements are met upon the employee's attaining age 25 and completing one year of service. *Id.* § 410(a)(1)(A).

33. "Total compensation" has been defined by the IRS in a number of rulings. Essentially, total compensation includes wages, commissions, bonuses, and tax-free receipts of food and lodging. Rev. Rul. 81-74, 1981-1 C.B. 175; Rev. Rul. 73-381, 1973-2 C.B. 125.

34. I.R.C. § 401(a)(5); Rev. Rul. 81-74, 1981-1 C.B. 175.

sation. Contributions would also be allowed if they were greater (as a percentage of total compensation) for the rank and file than they were for the prohibited group. In determining these proportions, however, an employer is allowed to take into account the social security contributions it has made on behalf of the employees.³⁵ The IRS has prescribed a number of rules which detail how these social security contributions may be taken into account.³⁶ The merit of these rules, commonly referred to as the "integration rules," will be the subject of subsequent discussion.³⁷

During the time a participating employee is working and contributions are being made to the qualified plan on the employee's behalf, that employee "accrues" benefits in the plan. In a defined contribution plan, the "accrued benefit" is represented by the aggregate of all contributions, earnings, and losses which have been allocated to the participant's account.³⁸ In a defined benefit plan, a participant's "accrued benefit" is some portion of the benefit payable at retirement age. Roughly speaking, the portion is determined with reference to a comparison of the employee's actual number of years of participation in the plan to the number of years of participation that would have been attained had the employee remained a participant until the plan's specified retirement age.³⁹ Thus, for example, an eleven-year participant who would have receive an estimated annual benefit of \$30,000 after thirty-three years of participation would currently have an accrued benefit of \$10,000 ($11/33 \times 30,000$).

Even though a participant has an accrued benefit, that benefit may nonetheless be forfeitable. A separate set of "vesting" rules determine the degree to which an accrued benefit is nonforfeitable.⁴⁰ Generally, a plan may select one of three prescribed vesting

35. I.R.C. § 401(a)(5).

36. See Rev. Rul. 71-446, 1971-2 C.B. 187.

37. See *infra* notes 106-26 and accompanying text.

38. I.R.C. § 411(a)(7)(A)(ii). In the case of profit sharing and stock bonus plans, the accrued benefit also includes any forfeitures which have been allocated to the participant's account. *Id.*

39. See *id.* § 411(b)(1)(C). Under the so-called "3-percent method" of accrual, 3% of the normal maximum retirement benefit must be accrued for each year of service. *Id.* § 411(b)(1)(A). Consequently, the proportional accrual rate described in the text (of actual years of participation to total potential years of participation) would not obtain under this method unless the participant had completed 33 years of service at retirement (i.e., 100% divided by 33 years equals approximately 3%).

40. See *id.* § 411(a)(2).

schedules. One commonly selected schedule is the so-called "ten-year vesting rule," under which a participant remains "zero vested" until he has completed ten years of service.⁴¹ Upon completion of the ten-year service period, the participant becomes 100% vested in his accrued benefit.⁴² With a so-called "top-heavy plan," to be discussed subsequently,⁴³ the plan must choose between two relatively accelerated vesting schedules—100% after three years of service or, starting with the second year of service, 20% annual increments resulting in 100% vesting after six years of service.⁴⁴

Limits are imposed on the amount that may be added annually to a participant's account in a defined contribution plan. Thus, the "annual addition"⁴⁵ to a participant's account in a defined con-

41. *Id.* § 411(a)(2)(A). Section 411(d)(1)(B) forbids the use of a vesting schedule which would tend to discriminate in favor of the prohibited group. In order to comply with this proscription, some of the newer and smaller companies that might be tempted by this type of discrimination have adopted a legislatively suggested "4-40" safe harbor vesting schedule. Under the 4-40 vesting schedule, the participant becomes 40% vested after four years of service, with additional vesting of 5% for each of the next two years and 10% for each of the following five years. H.R. REP. NO. 1280, 93d Cong., 2d Sess. 276-77, 1974-3 C.B. 415, 437-38, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 935.

42. I.R.C. § 411(a)(2)(A). Under § 411(a)(2)(B) (5 to 15 year vesting), the participant becomes 25% vested after five years of service, with additional vesting of 5% for each of the next five years and 10% for each of the following five years. Under § 411(a)(2)(C)(i) (Rule of 45), the vesting percentage corresponds to the sum of both years of service and age. Thus:

<i>If years of service equal or exceed —</i>	<i>and sum of age and service equals or exceeds —</i>	<i>then the nonforfeitable percentage is —</i>
5	45	50
6	47	60
7	49	70
8	51	80
9	53	90
10	55	100

Even if the threshold sum of 45 (employee's age plus the number of years of service) is not attained, any participant (younger than age 35) with 10 years of service would be 50% vested, with additional 10% vesting for each subsequent year of service. I.R.C. § 411(a)(2)(C)(ii).

43. See *infra* text accompanying notes 148-58.

44. I.R.C. § 416(b)(1) (special rules for top-heavy plans).

45. The "annual addition" equals the sum of employer contributions, employee contributions exceeding 6% of compensation, and, in the case of profit sharing and stock bonus plans, forfeitures. *Id.* § 415(c)(2). In the event that employee contributions exceed 12% of compensation, then one-half of those contributions, rather than the excess over 6% of compensation, is taken into account in determining the annual addition. *Id.*

tribution plan may not exceed the lesser of 25% of compensation or \$30,000.⁴⁶ Beginning in 1986, the \$30,000 alternative limit on the annual addition will be subject to an annual cost of living adjustment.⁴⁷

Limits are also imposed on the annual benefit that ultimately will be payable at retirement. Thus, the annual retirement benefit payable by a defined benefit plan may not exceed the lesser of either 100% of the average of the participant's three highest consecutive years of compensation, or \$90,000.⁴⁸ Starting in 1986, the \$90,000 alternative limit will be subject to an annual cost of living adjustment.⁴⁹

Overall limits are imposed on employees who are covered by both a defined contribution plan and a defined benefit plan. For higher-paid employees in this situation, no more than 125% of the defined contribution and defined benefit plan dollar limits may be used.⁵⁰ Thus, with respect to an employee with annual compensation of \$120,000, a \$30,000 annual addition may be made to the employee's defined contribution plan account, and a \$22,500 annual retirement benefit may be promised under a defined benefit plan. The 125% limit is not exceeded since the \$30,000 annual addition equals 100% of the defined contribution plan dollar limit (\$30,000/\$30,000) and the \$22,500 annual retirement benefit equals 25% of the defined benefit plan dollar limit (\$22,500/\$90,000).⁵¹

C. *Special Tax Treatment of Qualified Plans*

Certain retirement plans do not meet the qualified plan requirements and they are therefore referred to as "nonqualified plans." A brief description of the tax treatment of nonqualified

46. *Id.* § 415(c)(1).

47. *Id.* § 415(d)(1)(B), (d)(3).

48. *Id.* § 415(b)(1). The annual retirement benefit serving as the standard against which the limits are to be applied is a straight life annuity payable between ages 62 and 65. *Id.* § 415(b)(2)(A). Adjustments must be made to the dollar limit if the benefit is payable in a form other than a straight life annuity. *See id.* § 415(b)(2)(B). Adjustments must also be made to the dollar limit, so that it is equivalent to the standard benefit described above, if the benefit is payable either prior to age 62 or after age 65. *See id.* § 415(b)(2)(C)-(E).

49. *Id.* § 415(d)(1)(A), (d)(3).

50. *Id.* § 415(e)(3)(B)(i). For other employees, no more than 140% of the limitations may be used. *Id.* § 415(e)(3)(B)(ii).

51. The 125% limit also would be met in the case of a \$7500 annual addition (25% of \$30,000 limit) and a \$90,000 annual retirement benefit (100% of \$90,000 limit).

plans is helpful in understanding the special tax treatment accorded qualified plans.

A contribution to a nonqualified plan is includible in the employee's income for the year in which the nonforfeitable right to ultimately receive that contribution is attained.⁵² Correspondingly, the deduction of the employer's contribution is allowed for the year in which the contribution is includible in the employee's income.⁵³ Moreover, the trust serving as the funding mechanism of a nonqualified plan is subject to a tax each year on its income.⁵⁴

Subject to various limits, an employer making a contribution to a "qualified plan" on behalf of its employees is entitled to a deduction with respect to the taxable year in which the contribution is considered to have been made.⁵⁵ On the other hand, the employees for whom the contribution is made do not have to include any amount in income until the year in which a distribution is made to them by the trust.⁵⁶ Consequently, there may be a considerable period of time—twenty, thirty, or forty years—between the year that the deductible contribution is made and the year that it is included in income. During this time, all of the trust's income on its investments is exempt from taxation.⁵⁷

Other tax benefits flow from the qualified plan. The retirement benefits may be paid out over the employee's retirement years. A plan, for example, might provide for an annuity of \$25,000 per year to be paid over the remainder of the employee's life. Even though these payments are taxed as ordinary income, they usually are received at a time in life when the employee's overall income and corresponding marginal tax rate are below what they were during his active working years. Moreover, if upon retirement the employee receives a "lump sum distribution,"⁵⁸ special capital gains

52. I.R.C. § 402(b). Many nonqualified plans are not funded, and involve nothing more than the employer's unsecured promise that the deferred compensation will be paid at some future date. See Rev. Rul. 60-31, 1960-1 C.B. 174.

53. I.R.C. § 404(a)(5).

54. See *Philadelphia-Baltimore Exch. v. Commissioner*, 19 T.C. 355 (1957); *Lincoln Elec. Co. Employee's Profit-Sharing Trust v. Commissioner*, 14 T.C. 598 (1950), *rev'd on other grounds*, 190 F.2d 326 (6th Cir. 1951).

55. *Id.* § 404(a).

56. *Id.* § 402(a)(1).

57. *Id.* § 501(a).

58. Essentially, a "lump sum distribution" is a distribution during one taxable year to the participant of the total amount accumulated for that participant. *Id.* § 402(e)(4)(A). Moreover, the distribution must have been made as a result of the occurrence of one of

and averaging treatment obtain⁵⁹ so that the rate of taxation for the year of distribution is usually much lower than it would have been had the contribution been taxed the year it was made. Another special tax feature of qualified plans is the \$100,000 estate tax exclusion applicable to non-lump sum amounts payable after the participant's death.⁶⁰

The combination of the employer's current deduction for qualified plan contributions and the deferred taxation, usually at lower rates, of these contributions and the earnings thereon results in a significant amount of postponed tax revenue.⁶¹ In effect, the government is making a long-term, interest-free loan of these postponed taxes. The losses attributable to these interest-free loans are substantial. For fiscal year 1984, this amount has been estimated at \$34 billion.⁶² By 1988, this figure will reach an estimated \$65 billion.⁶³ Of all the "tax expenditures" resulting from various tax provisions allowing income exclusions, tax credits, deductions, and preferential tax rates,⁶⁴ the net exclusion of qualified plan contributions and earnings ranks first,⁶⁵ representing approximately 10% of all tax expenditures for fiscal year 1984⁶⁶ and 13% for fiscal year

certain prescribed events. Corporate and noncorporate qualified plan participants (or their beneficiaries) receive lump sum distribution treatment when the distribution is occasioned by the participant's death, attainment of age 59.5, or termination of employment. *Id.* § 402(e)(4)(A)(i)-(iii). However, sole proprietors and more than 10% partners do not qualify for this treatment where termination of employment was the impetus for the distribution. *Id.* § 402(e)(4)(A). Only sole proprietors and more than 10% partners qualify for this treatment where disability (prior to age 59.5) triggers the distribution. *Id.*

59. *Id.* § 402(a)(2), (e)(1).

60. *Id.* § 2039(c), (g). The exclusion also applies to otherwise lump sum distributions where the beneficiaries elect to forego the special capital gains and averaging treatments. *Id.* § 2039(f)(2).

61. To the extent that the taxes paid on distribution are less than the overall taxes that would have been imposed both at the times contributions were made and the times the trust had earnings, it is really a matter of lost, rather than postponed, revenue.

62. See STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 1ST SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1983-1988, at 16 (Comm. Print 1983) [hereinafter cited as JCT TAX EXPENDITURE ESTIMATES]. This report estimates a fiscal year 1984 tax expenditure of \$57.6 billion for both government and private sector plans. *Id.* The staff member responsible for these estimates has, in a telephone conversation, informed the author that approximately 59% of this expenditure (\$34 billion) is attributable to private sector qualified plans.

63. *Id.* This report estimates a fiscal year 1984 tax expenditure of \$110.25 billion for both government and private sector plans. *Id.* Thus, 59% = \$65 billion.

64. *Id.* at 2.

65. *Id.* at 10-17.

66. *Id.* at 18. This report reflects total fiscal year 1984 tax expenditures of \$327.5 bil-

1988.⁶⁷

D. *Policies Underlying Qualified Plan Provisions*

There are no significant economic differences between a qualified plan and a funded nonqualified plan⁶⁸ that might justify the disparity in taxation of these plans. Rather, it is a social policy rationale which underlies the qualified plan provisions.

The primary policy goal of the qualified plan provisions is to encourage employers to provide retirement savings for their employees.⁶⁹ The broad objective of ERISA was to increase the number of individuals participating in, and actually receiving benefits from, employer-financed plans.⁷⁰ Congress noted its awareness of the voluntary nature of the private pension system and the obvious concern of employers over the additional cost in meeting this objective:

Generally it would appear that the wider or more comprehensive the coverage, vesting and funding, the more desirable it is from the standpoint of national policy. However, since . . . the institution of new pension plans and increases in benefits depend upon employer willingness to participate or expand a plan, it is necessary to take into account additional costs from the standpoint of the employer. If employers respond to more comprehensive coverage, vesting, and funding rules by decreasing benefits under existing

lion. *Id.* The fiscal year 1984 tax expenditure of \$34 billion for private sector qualified plans represents approximately 10.4% of the total expenditures.

67. *Id.* This report reflects total fiscal year 1988 tax expenditures of \$490.9 billion. *Id.* The fiscal year 1988 tax expenditure of \$65 billion for private sector qualified plans represents approximately 13.2% of the total expenditures.

68. Like a qualified plan, a funded nonqualified plan usually entails employer contributions to a trust which ultimately will distribute retirement benefits to the covered employee-beneficiaries.

69. H.R. REP. NO. 2333, 77th Cong., 2d Sess. 50-51 (1942); S. REP. NO. 383, 93d Cong., 1st Sess. 10-11, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4890, 4898-99. Some contend that a significant underlying purpose of qualified plan deferred taxation is to provide an averaging device for personal service income. This averaging device, it is contended, serves to provide some tax parity between service performance income, which, without deferral, would be "bunched" into the service performer's working career, and income derived from capital investment, which is spread out on a relatively even basis over the capital owner's life. Snyder & Weckstein, *Quasi-Corporations, Quasi-Employees and Quasi-Tax Relief for Professional Persons*, 48 CORNELL L. REV. 613, 702 (1963). While the qualified plan provisions do have the effect of averaging service performance income, the pertinent 1921-1982 legislative history fails to indicate a congressional intent to provide any tax parity between this income and capital investment income.

70. S. REP. NO. 383, 93d Cong., 1st Sess. 10, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4890, 4898.

plans or slowing the rate of formation of new plans, little if any would be gained from the standpoint of securing broader use of employee pensions and related plans. At the same time, there are advantages in setting minimum standards . . . to serve as a guideline for employers in establishing or improving plans and also to prevent the promise of more in the form of pensions or related benefits than eventually is available.⁷¹

Thus, in many cases, the provisions of ERISA represent a compromise between the desire to enhance employee benefits and the necessity of controlling employer cost.⁷²

A seemingly logical way of containing employer cost is to reduce the benefits that the highly paid employee may accrue. In many cases, however, an employer's primary inducement to establish a qualified plan is to add an attractive component to the overall compensation package provided these individuals. In closely held companies, where many or all of the highly paid employees are also stockholders in the company, there obviously is an acute interest in establishing a qualified plan benefitting these employee-stockholders. In these contexts, the *cost* of providing benefits to the highly paid employees is not the greatest concern of the employer; on the contrary, the concern is the *upper limit* imposed on contributions and benefits for the highly paid employee. Thus, in attempting to provide employers with an adequate incentive to establish qualified plans covering low- and middle-income individuals, Congress has been pressured to set high upper limits on the contributions and benefits for the highly paid employees who are also plan participants. In setting such limits, however, Congress had to guard against providing an excessive tax deferral for these employees. Congress grappled with this issue in 1974 and again in 1982. The ensuing section deals with how well Congress has resolved the issue of excessive deferral.

71. *Id.* at 18-19, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4890, 4904.

72. The "employer cost" referred to is the additional cost of making overall contributions that results from allowing earlier participation and earlier vesting for those employees who, for the lack of lengthy employment, would not otherwise earn a significant vested benefit. Lower-paid employees, particularly women and minorities, tend to have a higher job turnover rate than middle- and higher-paid employees. PRESIDENT'S COMM'N ON PENSION POLICY, *supra* note 1, at 27-28. Consequently, a disproportionate part of the additional cost is attributable to the provision of earlier participation and vesting for these employees. However, this additional cost can be avoided in most cases by the use of integration. See *infra* notes 106-84 and accompanying text.

II. LIMITS ON CONTRIBUTIONS AND BENEFITS

A. *Evolution of Limits on Contributions and Benefits*

In 1921, when employer plans were few in number, the qualified plan provisions quietly crept into the law with very little legislative consideration.⁷³ During the fifty-three-year period preceding the enactment of ERISA, no direct limitations were imposed on corporate qualified plans with respect to either the annual contribution to defined contribution plans or the annual benefit from defined benefit plans.⁷⁴ Indirect limitations existed in the form of restrictions on the amount of deductible contributions, but nondeductible contributions were not subject to tax until they were distributed.⁷⁵

In contrast to the treatment afforded qualified plans of corporations, the qualified plans of unincorporated businesses (commonly referred to as "H.R. 10 plans")⁷⁶ were subject to rather severe contribution limits pertaining to the "owner-employee," someone defined essentially as a sole proprietor or more than 10% partner.⁷⁷ These plans were allowed to make no more than \$2500 of deductible contributions plus \$2500 of nondeductible contributions for each owner-employee.⁷⁸

ERISA imposed specific contribution and benefit limits on corporate qualified plans—an annual addition not exceeding

73. See *supra* note 7; see also Goodman, *Legislative Development of the Federal Tax Treatment of Pension and Profit-Sharing Plans*, 49 TAXES 226, 227 (1971). Cf. authority cited *supra* note 71.

74. H.R. REP. NO. 807, 93d Cong., 2d Sess. 110-11, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4670, 4775-76 [hereinafter cited as ERISA REPORT]. However, Rev. Rul. 72-3, 1972-1 C.B. 105, prohibited annual retirement benefits which exceeded the employee's compensation.

75. ERISA REPORT, *supra* note 74, at 110-11, reprinted in 1974 U.S. CODE CONG. & AD. NEWS at 4775-76. Moreover, the trust earnings attributable to nondeductible employee contributions were (and remained) nontaxable until the time of distribution.

76. This term is being used broadly to include also the qualified plans of so-called "Subchapter S corporations." Because these corporations, like partnerships, pass income and deductions directly through to the entity-owners, their qualified plans have been subject to essentially the same treatment as partnership and proprietorship qualified plans. See I.R.C. § 1379 (1970), repealed by Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (effective Jan. 1, 1984).

77. I.R.C. § 401(c)(3) (1976). With Subchapter S corporations, the shareholder-employer owning more than 5% of the corporation's stock was the target of the contribution restrictions. I.R.C. § 1379(d) (1970).

78. ERISA REPORT, *supra* note 74, at 110, reprinted in 1974 U.S. CODE CONG. & AD. NEWS at 4775.

\$25,000 or 25% of compensation, and an annual benefit not exceeding the lesser of \$75,000 or 100% of the average of the employee's three highest consecutive years of compensation.⁷⁹ It also increased (from \$2500 to \$7500) the maximum amount that could be contributed on a deductible basis to H.R. 10 plans, while continuing the pre-ERISA limit of \$2,500 on nondeductible contributions.⁸⁰ The committee report pertaining to these changes provides:

Your committee recognizes the importance of tax incentives in creating a strong private pension system. At the same time, however, your committee believes it is appropriate to provide some limitations to prevent the accumulation of corporate pensions out of tax-sheltered dollars which are swollen completely out of proportion to the reasonable need of individuals for a dignified level of retirement income. Moreover, by imposing limitations on corporate plans, and liberalizing the limitations which are imposed under present law on H.R. 10 plans, the Bill takes a long step forward to achieving tax equity in this area. . . . These provisions [pertaining to corporate qualified plans] do not limit the size of the pension which the employee may receive from a nonqualified plan, which is financed out of taxed dollars. The only effect of the provisions is to limit the size of the pension which is subsidized by the tax laws.⁸¹

The \$25,000 and \$75,000 contribution and benefit limitations were made subject to annual cost of living adjustments.⁸² By 1982, these limits had been raised to \$45,475 and \$136,425, respectively.⁸³ The obvious question in 1982, to use the ERISA committee report language, was whether "the accumulation of corporate pensions out of tax-sheltered dollars . . . [had] swollen completely out of proportion to the reasonable needs of individuals for a dignified level of retirement income."⁸⁴ The congressional response embodied in TEFRA was that the dollar limits should be lowered

79. ERISA § 2004(a)(2), 88 Stat. 829, 980-82 (1974) (current version at I.R.C. § 415(b)(1), (c)(1)).

80. This change is codified at ERISA § 2004(b), (e)(3), 88 Stat. 829, 952, 954-55 (1974) (current version at I.R.C. §§ 1379(b)(1), 401(e)). The pre-ERISA limit on nondeductible contributions is discussed in the ERISA REPORT, *supra* note 74, at 110, 113, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS at 4775, 4778.

81. ERISA REPORT, *supra* note 74, at 112-13, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS at 4777-78 (emphasis added).

82. ERISA § 2004(a)(2), 88 Stat. 829, 983 (1974) (current version at I.R.C. § 415(d)).

83. I.R. 82-18: *Employee Benefit Plans*, 9 FED. TAXES (P-H) ¶ 54,796 (News Release Feb. 3, 1982).

84. ERISA REPORT, *supra* note 74, at 112, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS at 4777.

to \$30,000⁸⁵ and \$90,000,⁸⁶ respectively. TEFRA also established parity between corporate and H.R. 10 qualified plans; both will now be subject to the same contribution and benefit limits.⁸⁷ Starting once again in 1986, these limits will be subject to cost of living adjustments.⁸⁸

B. *Merit of Current Limits on Contributions and Benefits*

Tax expenditures are not subject to any structured periodic review.⁸⁹ In contrast, direct federal expenditures are subject to annual budgetary and appropriation reviews by Congress and the executive branch. This distinction raises questions as to whether the size and allocation of the qualified plan subsidy would differ if it took the form of a direct federal expenditure instead of a tax expenditure.

Consider what might happen if Congress were to contemplate a direct expenditure program under which individuals would be encouraged to save for their retirement. One way of achieving this goal would be to match a certain percentage of the savings put aside by an individual in some account similar to an "IRA."⁹⁰ For example, if, in a particular year, an individual set aside \$1000, the government would make a 10% matching contribution of \$100. In formulating this program, Congress would have to determine who would be eligible for this subsidy. This determination would naturally be made by keeping in mind the initial need for such a program. The social security system does not provide an income which affords an adequate and dignified retirement subsistence for most Americans; this goal can only be attained by individual savings which would supplement social security. The individuals who must be encouraged and assisted to set aside these savings are those

85. TEFRA § 235(a)(2), 96 Stat. 324, 505 (1982) (amending I.R.C. § 415(c)(1)).

86. *Id.* § 235(a)(1) (amending I.R.C. § 415(b)(1)).

87. *Id.* § 238, 96 Stat. 512-13 (amending I.R.C. §§ 404(e), 401(j), 1379).

88. *Id.* § 235(b)(2), 96 Stat. 505 (amending I.R.C. § 415 (d)).

89. See *supra* note 64 and accompanying text.

90. Essentially, an "IRA," or "Individual Retirement Account," is a tax-exempt trust to which an individual can make annual deductible contributions not exceeding the lesser of \$2000 (\$2250 in the case of a married couple with one nonworking spouse) or 100% of compensation. I.R.C. §§ 219(a), (b)(1), (c), 408(a), (e)(1) (1976 & Supp. V 1981). Amounts distributed are treated as ordinary income and, except for disability cases, there is an additional 10% tax with respect to distributions occurring before age 59.5. I.R.C. § 408(d)(1), (f) (1976).

with the least ability to save. High-income individuals have the ability to save and do not need governmental assistance in this regard. It therefore would be illogical and wasteful for the government to provide unneeded assistance to these individuals. Consequently, if the issue of governmental subsidization of retirement savings were being considered for the first time in the context of an appropriated expenditure, this subsidy would in all likelihood be directed almost exclusively to the people who need it—lower- and middle-income individuals. Of course, the issue has not been considered in this context, and the outcome has been quite different. An examination of the amounts that high-income individuals can accumulate under the qualified plan provisions is revealing.

It is possible under the current qualified plan provisions for an individual earning \$120,000 or more annually to accumulate approximately \$8.6 million by age sixty-five.⁹¹ This accumulation could buy a sixty-five year old male retiree a single life annuity of approximately \$1 million per year.⁹² Moreover, if the individual had also been funding an IRA,⁹³ an additional \$560,000 could be accumulated by age sixty-five.⁹⁴ This would bring the total tax-de-

91. This computation is made on the assumption that participation begins at age 25 and continues to age 65 in both a defined contribution plan and a defined benefit plan. The maximum \$30,000 contribution is made in each of 40 years to the defined contribution plan and the defined benefit plan is funded in order to provide 25% of the maximum annual benefit of \$90,000; i.e., \$22,500. This combination of 100% of the defined contribution limit and 25% of the defined benefit limit meets the 125% upper limit applicable to combined plans. I.R.C. § 415(e)(1)-(3). Assuming an annual 8% earnings rate over a 40-year period (ages 25-65) and a 15-year life expectancy after retirement, the defined contribution plan would accumulate \$8,393,430 and the defined benefit plan would accumulate \$192,578—a total of \$8,586,008.

If our hypothetical employee did not begin participation until age 35, the defined contribution plan accumulation after 30 years, assuming an 8% annual earnings rate, would be \$3,670,380. With the defined benefit plan accumulation of \$192,578, the total accumulation at age 65 would be \$3,862,958.

If our hypothetical employee did not begin participation until age 45, the defined contribution plan accumulation after 20 years, assuming an 8% annual earnings rate, would be \$1,482,690. With the defined benefit plan accumulation of \$192,578, the total accumulation at age 65 would be \$1,675,268.

None of the above computations takes into account the annual inflation adjustments to the dollar limits.

92. Assuming a 15-year life expectancy and an 8% annual earnings rate, the defined contribution plan accumulation of \$8,393,430 could buy an annuity of \$962,894. When this annuity is combined with the \$22,500 defined benefit plan annuity, the total annuity becomes \$985,394.

93. See *supra* note 90.

94. Assuming \$2000 contributions for each of 40 years, with an annual earnings rate of

ferred savings to \$9.2 million. Clearly, \$9.2 million provides far in excess of the "reasonable needs of [an] individual . . . for a dignified level of retirement."⁹⁵ Moreover, by foregoing income taxation of one individual over a forty-year period on amounts ultimately totalling as much as \$9.2 million, this country is providing an unjustifiable tax subsidy which seriously erodes the income tax base and undermines the already shaken public confidence in the fairness of our tax system.

Even if the amount of contributions and trust earnings shielded from taxation were the same for low-, middle-, and high-income individuals, the subsidy per dollar of tax-deferred contributions and earnings would still be greater for the high-income individual. For example, while the tax deferral on a \$2000 contribution for an individual having a marginal tax bracket of 50% would be \$1000, the tax deferral on that same contribution for an individual having an 18% marginal tax bracket⁹⁶ would only be \$360. The tax subsidy for the high-income individual is almost three times as great as that for the middle-income individual.

It can be argued that the tax deferral involved here, like all deductions and exclusions, appropriately yields a greater dollar savings for the high-bracket taxpayer. While this argument is certainly logical with respect to the deduction of various expenses related to the generation of the income that has put the taxpayer in a high tax bracket,⁹⁷ it is questionable in the context of a tax deferral provision which owes its existence to the government's social policy of providing a dignified level of retirement income to its citizens. Regardless of its form, public aid should not increase as the need for this aid decreases.

It can also be argued that if the contribution and benefit limits were lowered for higher-paid employees, plans would be amended to provide a lower contribution or benefit structure for the rank and file. As the following illustration demonstrates, such a result is not compelled. Assume, under the current limits, a pen-

8%, \$559,562 would be accumulated by age 65.

95. ERISA REPORT, *supra* note 74, at 112, reprinted in 1974 U.S. CODE CONG. & AD. NEWS at 4777.

96. For taxable years beginning after 1983, the range of taxable income subject to the joint return tax rate of 18% is \$16,000-\$20,200. I.R.C. § 1(a)(3).

97. The argument would also be logical with respect to the charitable deduction. In this situation, the ability to give aid, in contrast to the need to receive it, increases as income rises.

sion plan provides for annual contributions equal to the lesser of either 25% of compensation or \$30,000. One of the participants, *A*, earns \$150,000 a year and, therefore, has \$30,000 contributed to the plan each year on his behalf. Another participant, *B*, earns \$10,000 a year and, therefore, has \$2500 contributed to the plan each year on his behalf. Assume now that Congress changes the contribution limits to the lesser of 25% of compensation or \$10,000 (decreased from \$30,000). The plan *could* simply be amended to provide contributions not in excess of the new limits, thereby resulting in annual contributions of \$10,000 and \$2500 to *A* and *B*, respectively. In relation to salary, *B*, the low-income individual, would be receiving a substantially greater percentage ($\$2500 \div \$10,000 = 25\%$) of tax-subsidized contribution than *A* ($\$10,000 \div \$150,000 = 6.66\%$), the high-income individual. However, if we assume that *A* is in the 50% tax bracket and *B* is in the 15% tax bracket and then compare the tax deferral in relation to compensation, we see that the amount of tax deferral for *A*, \$5000 (50% of \$10,000), is only a slightly lesser proportion of his salary ($\$5000 \div \$150,000 = 3.33\%$) than the tax deferral for *B*, \$375 (15% of \$2500), in relation to his salary ($\$375 \div \$10,000 = 3.75\%$). Thus, substantially lowered contribution and benefit limits *could* bring about something approaching rationality in terms of the relation of this socially motivated tax deferral to the amounts of compensation of high- and low-income individuals.

With respect to the above illustration, the high-limit proponents would point out that many plans would not only lower the dollar limit to \$10,000, but would also lower the percentage to the point at which the higher-paid individuals would still receive the maximum \$10,000 amount. Thus, in the above illustration, the plan would lower the contribution percentage to 6.66%. This would still result in a \$10,000 contribution for *A*, but would lower the contribution for *B* to \$666, a 73% reduction of \$1834 ($\$2500 - \666). The percentage of tax deferral in relation to compensation for *A* (3.33)⁹⁸ would now be more than three times as much as that for *B* (1.00).⁹⁹ This is an example of the economic hardball that would inevitably be played—if it were not foreseen and prevented.

98. The tax deferral would be \$5000 (50% of \$10,000). A \$5000 tax deferral \div \$150,000 = 3.33%.

99. The tax deferral would be \$100 (15% of \$666). A \$100 tax deferral \div \$10,000 = 1%.

The way to prevent this inequitable allocation of the qualified plan tax subsidy is to also limit the amount of compensation that a plan may take into account in determining the amounts of contributions and benefits. Accordingly, the upper limit on compensation could be set at some modest level such as \$40,000. If *A* is to receive the full \$10,000 contribution, the plan would have to set the contribution percentage at 25%, which would enable *B* to receive the \$2500 contribution.

The ultimate and most cogent argument of the high-limit proponents is that lowered contribution and benefit limits, particularly when combined with limits on the compensation to be taken into account, would result in the termination of many qualified plans.¹⁰⁰ High-limit proponents argue that these changes would substantially reduce the attractiveness of this deferred compensation device for higher-paid employees, and therefore the employer would no longer have any incentive to maintain a qualified plan. Instead, the employer would establish nonqualified plans exclusively for the higher-paid employees,¹⁰¹ leaving the rank and file with no form of deferred compensation plan.

In response to such threats, it should first be noted that no real loss is suffered upon the termination of those plans whose use of the eligibility, vesting, and integration rules has resulted in the provision of little or no retirement security for the rank and file employees. Nonetheless, a good number of plans do provide some

100. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES, 63 (Comm. Print 1982) [hereinafter cited as REVENUE OPTIONS].

101. Title I of ERISA contains a number of non-tax rules which are subject to enforcement through federal district court suits brought by plan fiduciaries, participants, or the Labor Department. 29 U.S.C. §§ 1131-1132 (1976 & Supp. V 1981). Except for the sanction, the Title I participation, benefit accrual, vesting, and funding rules are almost identical to the tax rules contained in Title II of ERISA. Compare 29 U.S.C. §§ 1051-1054, 1081-1082 (1976 & Supp. V 1981) with I.R.C. §§ 410-412 (1976 & Supp. V 1981). However, at least initially, Title I applies to both qualified and nonqualified plans. 29 U.S.C. §§ 1002(1)-(3), 1003(a), 1051, 1081 (1976 & Supp. V 1981). A major exception to the application of these provisions obtains for those plans which are "unfunded and . . . maintained . . . primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees . . ." 29 U.S.C. §§ 1051(2), 1081(a)(3) (1976). Title I also exempts unfunded "excess benefit plan[s]" that provide for the future payment of those contributions and benefits which exceed the applicable contribution and benefit limits of I.R.C. § 415. See 29 U.S.C. § 1003(b)(5) (1976). Thus, in order to avoid the rigorous Title I participation, benefit accrual, vesting, and funding rules, a nonqualified plan must be both unfunded and exclusively for the benefit of the higher-paid employees.

retirement security for the rank and file. The number of these plans that would terminate as the result of the lowering of the contribution, benefit, and compensation limits depends to a great extent on the degree of confidence that higher-paid employees would have in the nonqualified plans which would serve as their alternative deferred compensation vehicles.

While there are many variations, the typical nonqualified plan consists of nothing more than the employer's unsecured promise to pay a certain amount of deferred compensation in the future.¹⁰² Because the agreement to defer is made prior to the time the compensation is earned, and the employee has received nothing but the unsecured promise of the employer, taxation (and the employer's deduction) is deferred to the time that the employer fulfills its promise and makes the agreed-upon payments.¹⁰³ While tax deferral is achieved under this arrangement, the employee does not have the security provided by a qualified plan of actually having the deferred compensation set aside and waiting in a trust fund. This lack of tangible security may not be a problem for an executive of General Motors or Exxon, but, in these quickly changing and very uncertain economic times, there are very few employees who can assuredly say that their employer will be in existence and financially solvent to pay a promised retirement benefit in ten, twenty, or thirty years. Consequently, because of the security it provides, many higher-paid employees would probably want to continue having part of their deferred compensation funded under a qualified plan, with the remaining amount of their deferred compensation which exceeds the lowered limits being subject to some sort of nonqualified plan. In short, while it is not nearly as bountiful as previous days, most highly-paid employees would still opt for *some* qualified plan retirement security rather than *none*.

102. See *supra* note 101 for the reasons that a nonqualified plan would probably not be funded. An additional reason to choose an unfunded plan stems from one of the tax rules. An employee's share of a funded, nonqualified plan is currently taxed unless that share is subject to a substantial risk of forfeiture. I.R.C. §§ 83, 402(b); Treas. Reg. § 1.83-3(c). Since a substantial risk of forfeiture (e.g., forfeiture upon failure to maintain employment until the designated distribution date) might result in the loss of benefits, many employees opt for the unfunded, nonqualified plan. While less secure, the unfunded, nonqualified plan defers taxation without necessarily entailing a forfeiture provision. Rev. Rul. 60-31, 1960-1 C.B. 174-81. *But see* Rev. Proc. 71-19, 1971-1 C.B. 698 (requiring a forfeiture provision in the event of an election to defer which is made subsequent to the rendition of services that gave rise to the deferred compensation).

103. I.R.C. § 404(a)(5); Rev. Rul. 60-31, 1960-1 C.B. 174-81.

Notwithstanding the drawbacks of nonqualified plans, substantially lowered contribution, benefit, and compensation limits would serve as the impetus for the termination of a good number of qualified plans. These lowered limits would probably prove more unsettling to smaller, closely-held companies which tend to view the qualified plan as a deferred profit plan primarily for the benefit of the employee-stockholders. Consequently, a high percentage of the plan terminations would be attributable to these companies.

Any qualified plan termination would cause immediate full vesting in all funded accrued benefits.¹⁰⁴ Consequently, the participants in these terminated plans would not lose the benefits that thus far had accrued. However, while there may be some increase in current compensation for employees as a result of the elimination of the employer's cost of contributing to the qualified plan, the rank and file employee would be left in the same predicament as that of approximately 50% of all rank and file employees—lacking any structured, employer-administered, retirement savings plan. Of course, these employees could always put some money into an IRA,¹⁰⁵ but this is very hard to do with a limited disposable income. In most cases, consumption will win out over savings, and rank and file employees ultimately will have less retirement security as a result of the termination of those qualified plans that provided modest contributions and benefits.

Perhaps the very real prospect of this loss should give one pause to reconsider the wisdom of lowering the limits; even if a regal subsidy is provided for the higher paid, it may be worthwhile so long as a substantial number of the rank and file are also reaping some benefits. The next Section analyzes this prospect by focusing on the effect of the integration rules upon the ability of the rank and file to obtain a meaningful share of this subsidy.

III. INTEGRATION

A. *An Overview of Integration Rules*

In 1942 Congress decided that a qualified plan should not be allowed to discriminate in favor of officers, shareholders, or highly compensated employees.¹⁰⁶ As previously described,¹⁰⁷ the anti-dis-

104. I.R.C. § 411(d)(3).

105. See *supra* note 85.

106. Revenue Act of 1942, ch. 619, § 162(a), 56 Stat. 862.

crimination rules relate both to the breadth of employee coverage and the allocation of contributions and benefits among the covered employees. In regard to the allocation of contributions and benefits, the percentage of "total compensation" that is represented by contributions or benefits must be at least as high for the rank and file as it is for the prohibited group.¹⁰⁸

At the same time that Congress prescribed the anti-discrimination requirements, it also sanctioned the use of "integration."¹⁰⁹ In determining the percentages of total compensation that is represented by contributions or benefits for both the prohibited and rank and file groups, the integration rules allow the employer to take into account either the social security contributions it has made on behalf of the employees or the social security benefits to be derived from these contributions.

Integration therefore provides for the coordination of two retirement plans—the social security system and the qualified plan. Equal amounts of social security taxes are imposed annually on employer and employee with respect to a limited amount of the employees' wages. The limit on annual wages subject to social security taxes is referred to as the "taxable wage base." As a result of various enactments and built-in indexing, the taxable wage base has increased from \$3000 in 1942, to \$37,800 in 1984. A retiree's social security benefits are determined with reference to his "average indexed monthly earnings."¹¹⁰ The maximum amount of yearly earnings taken into account in computing the retiree's average indexed monthly earnings corresponds to an average of the taxable wage bases in effect during that individual's career ("covered compensation").¹¹¹

107. See *supra* notes 25-37 and accompanying text.

108. *Id.*

109. In speaking on the integration of pension plans with the social security system, the committee report provided that:

[A] plan in good faith designed to supplement the benefits under the Social Security Act . . . by making eligibility to the benefits of the plan dependent upon an employee receiving annual compensation in excess of \$3000, will not be considered by reason of that fact as based upon favoritism to high compensated employees.

H.R. REP. No. 2333, 77th Cong, 2d Sess. 104 (1942).

110. D. MCGILL, FUNDAMENTALS OF PRIVATE PENSIONS 11 (1979).

111. Rev. Rul. 71-446, § 2.03, 1971-2 C.B. 187, 188. The taxable wage bases of concern to a 1983 retiree are: \$3600 for 1954; \$4200 for 1955-1958; \$4800 for 1959-1965; \$6600 for 1966-1967; \$7800 for 1968-1971; \$9000 for 1972; \$10,800 for 1973; \$13,200 for 1974; \$14,100

To the extent that social security benefits are attributable to employer-paid taxes, integration treats the social security system as an *employer plan*, the purpose of which is to provide a certain level of wage replacement with respect to each employee's covered compensation. Thus, if the other employer plan, the qualified plan, provides the same percentage of wage replacement with respect to compensation in excess of covered compensation as that provided by the employer's social security plan with respect to covered compensation, the two benefits together would provide a nondiscriminatory benefit for all employees. For example, if it were determined that employer-paid taxes were providing social security benefits that represented 37.5% of covered compensation, then no discrimination would occur if the employer's qualified plan only provided benefits equal to 37.5% of compensation in excess of covered compensation. No discrimination occurs because the two plans, viewed together, provide both rank and file and prohibited group employees with the same percentage (37.5) of wage replacement.

A qualified plan may be integrated under either the "excess method" or the "offset method." Under the excess method, which has a number of different formulations, social security is taken into account by providing contributions or benefits only with respect to compensation above the "integration level."¹¹² Over the years, the IRS has developed a body of excess method rules which pertain to the appropriate selection of both the "integration level" and the percentage of contributions or benefits with respect to compensation above this level. The "integration level" is that level of compensation below which no contributions or benefits need be provided.¹¹³ The acceptable integration level alternatives are all tied in some way to the taxable wage base. Thus, one appropriate integration level would be a particular individual's covered compensation.¹¹⁴ In other cases, an appropriate integration level, applied on a year-by-year basis, would be the taxable wage base for the particular year in question.¹¹⁵ Another appropriate integration level is a

for 1975; \$15,300 for 1976; \$16,500 for 1977; \$17,700 for 1978; \$22,900 for 1979; \$25,900 for 1980; \$29,700 for 1981; \$32,400 for 1982; and \$35,700 for 1983.

112. Rev. Rul. 71-446, §§ 2.05-2.07, 1971-2 C.B. 187, 188.

113. *Id.* § 2.05, 1971-2 C.B. at 187.

114. *Id.* §§ 5.01, 6.01, 14, 15, 1971-2 C.B. at 189, 190, 194.

115. *Id.* §§ 6.01, 14, 15, 1971-2 C.B. at 190, 194.

stated dollar amount which is less than one of the IRS prescribed integration levels.¹¹⁶

The second facet of the excess method integration rules involves the prescription of limits on the percentages of contributions or benefits with respect to compensation above the integration level. Different limits are prescribed depending on the type of plan involved. For these purposes, defined benefit plans are bifurcated into "flat benefit plans" and "unit benefit plans."

A "flat benefit plan" is a defined benefit plan whose benefit formula does not take years of service into account. The current flat benefit plan rules limit the percentage of benefits with respect to compensation above the integration level to 37.5%.¹¹⁷ Thus, a flat benefit plan would be appropriately integrated if it provided a retirement benefit equal to 37.5% of the participant's average compensation in excess of an acceptable integration level.

A "unit benefit plan" is a defined benefit plan whose benefit formula does take years of service into account. With respect to each year of service, a unit benefit plan may not provide a benefit exceeding 1% of the participant's average compensation in excess of an acceptable integration level.¹¹⁸

Defined contribution plans are subject to yet another excess method percentage limit. Until recently, contributions and forfeitures allocated to participant's accounts in defined contribution plans could not exceed 7% of the compensation above the integration level.¹¹⁹ TEFRA replaced the 7% limit with the rate of the social security tax imposed on the employer each year for Old-Age, Survivors, and Disability Insurance (OASDI).¹²⁰ The current (1983) rate of 5.4% will gradually escalate to 6.2% by 1990.¹²¹

An acceptable and commonly employed variation of the excess method is the so-called "step-rate method." This method allows an

116. *Id.* §§ 5.01, 6.01, 14, 15, 1971-2 C.B. at 189, 190, 194.

117. *Id.* § 5.02, 1971-2 C.B. at 189. However, the flat benefit is reduced by 2.5% for each year of service below 15. *Id.* For example, an employee retiring with 13 years of service would be entitled to a flat benefit equal to 32.5% [$37.5 - (2 \times 2.5)$] of the amount by which his average annual compensation exceeded the integration level.

118. *Id.* § 6.03, 1971-2 C.B. at 190. However, if average compensation is determined by reference to the compensation paid over the entire career of the employee, a 1.4% benefit may be paid for each year of service. *Id.* § 6.02. In this situation, the benefit formula would be $1.4\% \times (\text{years of service}) \times (\text{average compensation in excess of the integration level})$.

119. *Id.* §§ 14.01, 15.02, 1971-2 C.B. at 194.

120. I.R.C. § 401.

121. *Id.* § 3111(a)(5), (7).

increase in the percentage limits for contributions or benefits with respect to compensation above the integration level so long as there is a corresponding increase for contributions or benefits below the integration level.¹²² Thus, while the limit for flat benefits with respect to compensation above the integration level may be 37.5%, this limit could be raised, for example, by 12.5% up to 50%, so long as a 12.5% benefit is then paid with respect to compensation below the integration level.¹²³ In this same vein, if the 1983 5.4% limit for contributions with respect to compensation above the integration level were raised by 4.6%, up to 10%, then contributions of 4.6% would be required with respect to compensation below the integration level.

Instead of the excess method, a defined benefit plan may employ the "offset method" of integration. Under this method, the employee's benefit is computed as it normally would be if the plan were not integrated. However, the benefit is offset by a certain percentage of the social security benefit to which the employee is entitled at retirement.¹²⁴ Currently, the upper limit for the offset is 83.33%.¹²⁵ For example, a defined benefit plan would be properly integrated if it provided a retirement benefit equal to 50% of average compensation less 83.33% of the social security benefit receivable by the retiring employee.¹²⁶

B. *Legislative Consideration of Intégration*

In its 1974 ERISA deliberations, the House Ways and Means Committee made the following statement about integration:

[T]he objective of Congress in increasing social security benefits might be considered to be frustrated to the extent that individuals with low and moderate income have their private retirement benefits reduced as a result of the integration procedures. On the other hand, your committee is very much

122. Rev. Rul. 71-446, § 16, 1971-2 C.B. 187, 194-95.

123. An example of a unit benefit plan step-rate formula would be:

.5% × (years of service) × (average compensation *below* the integration level)
plus

1.5% × (years of service) × (average compensation *above* the integration level).

Since .5% was added to the normal 1% limit (assuming an average of only the last 5 years of compensation) with respect to average compensation above the integration level, that .5% is also applied with respect to average compensation below the integration level.

124. Rev. Rul. 71-446, § 2.07, 1971-2 C.B. 187, 188.

125. *Id.* § 7.01, 1971-2 C.B. at 190.

126. See *infra* note 160 for an example of the offset method.

aware that many present plans are fully or partially integrated and that elimination of the integration procedures could substantially increase the cost of financing private plans. Employees, as a whole, might be injured rather than aided if such cost increases resulted in slowing down the rate of growth of private retirement plans.¹²⁷

With these competing considerations in mind, the Committee decided to continue allowing the use of integration.¹²⁸ However, it did decide to prohibit integrated plans from using post-retirement increases in the taxable wage base or social security benefit levels to reduce the retirement benefit of a retired employee.¹²⁹ The Conference Committee of the House Ways and Means Committee and the Senate Finance Committee decided to go one step further by freezing integration at the 1971 social security levels until July 1, 1976.¹³⁰ However, after reportedly receiving a tremendous outcry of protest from employers, banks, and life insurance companies, Congress relented and deleted the freeze provision.¹³¹

As part of its massive 1978 tax reform program,¹³² the Carter administration proposed a number of changes that, it contended, would render the integration rules more equitable in the treatment of lower-paid persons.¹³³ The basic theme of these proposals was to assure the provision of some benefits for the lower-paid. Thus, any excess plan lacking step-rate features would have been eliminated.¹³⁴ Moreover, all step-rate excess plans would have been subject to a maximum 180% rule.¹³⁵ Under this rule, contributions or benefits attributable to compensation above the integration level could be no more than 180% of the contributions or benefits attributable to compensation below the integration level.¹³⁶ For example, if a 9% contribution was to be made with respect to com-

127. ERISA REPORT, *supra* note 74, at 29, reprinted in 1974 U.S. CODE CONG. & AD. NEWS at 4696.

128. *Id.*

129. *Id.*

130. H.R. REP. NO. 1280, 93d Cong., 2d Sess. 280-81 (1974), reprinted in 1974 U.S. CODE CONG. & AD. NEWS 5038, 5061.

131. H.R. CON. RES. 609, 93d Cong., 2d Sess., 120 CONG. REC. 29,216-19, 29,925-28 (1974).

132. H.R. 12,078, 95th Cong., 2d Sess., 124 CONG. REC. 9933 (1970).

133. DEPARTMENT OF THE TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM, FACT SHEET 20 (1978) [hereinafter cited as THE PRESIDENT'S TAX PROGRAM].

134. H.R. 12,078, 95th Cong., 2d Sess. § 251(2) (1978).

135. *Id.*

136. *Id.*

pensation above the integration level, a 5% contribution would be required with respect to compensation below the integration level.¹³⁷ These proposals also contained a change in the offset plan rules. Under this proposed change, the percentage of offset could not exceed the percentage that was used to establish the benefit.¹³⁸ For example, if a defined benefit plan called for a benefit equal to 50% of average compensation, the percentage of offset could not exceed 50%.

While most of the Carter tax proposals were accepted, the House Ways and Means Committee, without debate,¹³⁹ deleted the integration proposals from the bill. When the bill came up for consideration in the Senate, the Carter administration sought to revive a number of proposals that had been deleted by the House Ways and Means Committee.¹⁴⁰ However, no attempt was made to revive the integration proposals.

In 1982, Congressman Rangel introduced H.R. 6410,¹⁴¹ which contained, *inter alia*, a number of changes pertaining to integration. One of these changes, which was ultimately enacted as part of TEFRA, reduced the 7% rate, for contributions above the integration level, to the OASDI tax rate.¹⁴² The current (1983) rate of 5.4% will gradually escalate to 6.2% by 1990.¹⁴³ Two other proposed changes were not enacted. The first change would have limited the offset by a defined benefit plan to the annual annuity that could be purchased by the employer's actual OASDI tax payments with respect to the particular employee involved.¹⁴⁴ The purpose of this change was to preclude an employer (or employers) from claiming an offset attributable to the OASDI contributions made by previous employers of the employee.¹⁴⁵ The other change pro-

137. $5\% \times 1.8 = 9\%$.

138. See *supra* note 134.

139. These proposals were discussed before, but not acted upon by, other House non-tax committees. See, e.g., *National Pension Policies, Private Pension Plans: Hearings Before the Subcomm. on Retirement Income & Employment of the Select Comm. on Aging*, 95th Cong., 2d Sess. 43-50 (1978) (statement of D. Halperin, Tax Legislative Counsel, Dep't of the Treas.).

140. *Hearings on H.R. 13511 Before the Senate Comm. on Finance*, 95th Cong., 2d Sess. 130-201 (1978) (statement of W. Blumenthal, Sec'y of the Treas.).

141. H.R. 6410, 97th Cong., 2d Sess. (1982).

142. *Id.* § 4.

143. I.R.C. § 3111(a)(5), (7).

144. See *supra* note 142.

145. REVENUE OPTIONS, *supra* note 100, at 66-67.

vided a so-called "1-2-1" safe harbor rule for defined benefit plans which were integrated under the excess method.¹⁴⁶ Under this proposal, benefits based on compensation exceeding \$60,000 could be no greater than benefits based on compensation below \$30,000, whereas benefits based on compensation falling between \$30,000 and \$60,000 could be twice those based on compensation above and below this range.¹⁴⁷

C. TEFRA's Top-Heavy Rules

TEFRA contained the "top-heavy" rules¹⁴⁸ which, when applicable, modify the consequences of the integration rules in certain instances. These rules affect those qualified plans which are considered to be weighted too heavily in favor of "key employees" such as officers, employees with the ten largest ownership interests in the employer, employees with at least 5% ownership interests in the employer, and employees with at least both 1% ownership interests in the employer and annual compensation of \$150,000.¹⁴⁹ Thus, a plan is considered "top-heavy," and, therefore, subject to a number of special requirements, if, as of the "determination date,"¹⁵⁰ the accrued benefits¹⁵¹ for the key employees exceed 60% of the accrued benefits of all participants.¹⁵² Obviously, the qualified plans of smaller, closely-held companies will be more apt to become subject to these provisions.¹⁵³

If a plan is top-heavy, then it will become subject to a number of special rules, one of which is the requirement that all "non-key employees"¹⁵⁴ receive minimum contributions or benefits.¹⁵⁵ Thus,

146. See *supra* note 142.

147. H.R. 6410, 97th Cong., 2d Sess. (1982).

148. See I.R.C. § 416.

149. *Id.* § 416(i)(1).

150. Generally, the "determination date" with respect to the current plan year is the last date of the preceding plan year. *Id.* § 416(g)(4)(C).

151. "Accrued benefits" refers to amounts accrued under both defined benefit and defined contribution plans. See *id.* § 411(a)(7)(A).

152. *Id.* § 416(g)(1)(A)(i).

153. The prospect of a plan being top-heavy increases as the ratio of higher-paid participants to rank and file participants increases. Moreover, since integration allocates a disproportionate amount of plan benefits or contributions to the higher-paid, this prospect is further increased when the plan is integrated. Thus, in contrast to the larger companies, small, closely-held companies with integrated plans are far more likely to have top-heavy plans.

154. I.R.C. § 416(i)(2).

for each non-key employee-participant, a top-heavy defined contribution plan is required to make a minimum annual contribution equal to 3% of compensation.¹⁵⁶ For each year that a defined benefit plan is top-heavy, each non-key employee-participant must accrue a benefit equal to 2% of his average compensation.¹⁵⁷ This minimum benefit rule becomes inapplicable after the employee has accumulated an accrued benefit equal to 20% of average compensation.¹⁵⁸

To the extent that they would cause a non-key employee-participant in a top-heavy plan to receive less than the prescribed minimum contributions or benefits, the integration rules must give way to the top-heavy rules.¹⁵⁹ When applicable, these minimum rules will impact least upon those step-rate excess plans which provide some contribution or benefit with respect to compensation falling below the integration level. There is a greater likelihood that the impact will be felt by those top-heavy defined benefit plans which are integrated under the offset method, particularly where the offset is as high as 83.33% and the employee is at the lower end of the wage scale.¹⁶⁰

155. *See id.* § 416(c).

156. *Id.* § 416(c)(2)(A). However, a less than 3% contribution may be made if that same percentage is contributed for the key employees and these employees are not covered by a defined benefit plan. *Id.* § 416(c)(2)(B). Compare note 157 regarding an employer with both defined benefit and defined contribution plans.

157. *Id.* § 416(c)(1). Generally, average compensation is determined by reference to the participant's five consecutive years of highest compensation from the employer. *Id.* § 416(c)(1)(D). Both the minimum benefit and minimum contribution need not be provided where the employer has a defined benefit plan and a defined contribution plan. *Id.* § 416(f). Generally, in this situation, the proposed regulations call for the provision of the 2% minimum benefit rather than the 3% minimum contribution. See 48 Fed. Reg. 10,869 (1983) (to be codified at Treas. Reg. § 1.146-1) (proposed Mar. 15, 1983); see also *Questions and Answers on Top Heavy Plans at M-10: What minimum contribution or benefit must be received by a non-key employee?*, 5 FED. TAXES (P-H) ¶ 19,580. A number of other options are provided. *Id.*

158. I.R.C. § 416(c)(1)(B)(ii).

159. *Id.* § 416(e).

160. In many cases, a high percentage offset either nearly or completely eliminates the pension benefit of lower-paid employees. For example, in the case of a defined benefit plan which provides a 2% benefit for each year of service, subject to an 83.3% OASDI offset, an employee with average annual earnings of \$10,000, 20 years of service, and an approximate annual Social Security benefit of \$5880, would receive no pension benefit as a result of the offset (pension benefit of \$4000 ($\$10,000 \times .02 \times 20$) less offset of \$4900 ($83.33\% \times \$5880$)). Many large employers reportedly do not use the highest allowable (83.33%) offset.

D. *Is Integration Justified?*

The previous analysis of the contribution and benefit limitations casts substantial doubt as to whether the qualified plan system is worth maintaining in its current state. The following analysis of the integration process casts further significant doubt upon the merit of this system.

Consider the hypothetical case of a company that has a nonintegrated money purchase plan which, in 1983, covers four participants—three rank and file individuals, *A*, *B*, and *C*, annually earning \$10,000, \$15,000, and \$20,000, respectively, and one stockholder-executive, *D*, annually earning \$150,000. The plan makes contributions equal to 8.4% of compensation, resulting in contributions for *A*, *B*, *C*, and *D* of \$840, \$1260, \$1680, and \$12,600, respectively. Assuming marginal tax brackets of 14, 16, 18, and 50%, the resulting percentages of tax deferral subsidy to compensation for *A*, *B*, *C*, and *D* are approximately 1.2, 1.3, 1.5, and 4.2, respectively.¹⁶¹ Thus, *D*'s percentage of tax deferral subsidy to compensation is approximately three to three and a half times as great as those percentages for *A*, *B*, and *C*.¹⁶²

Assume now that, with an integration level of \$20,000, the plan is integrated on the step-rate basis of 3% below the integration level and 8.4% above that level.¹⁶³ The contributions for *A*, *B*, *C*, and *D* in 1983 would be \$300, \$450, \$600, and \$11,520, respec-

161. With a marginal tax rate of 14%, the amount of tax deferral for *A* is \$117.60 (14% of \$840 contribution). The percentage of tax deferral to compensation for *A* is therefore 1.17 ($\$117.60 \div \$10,000$). With a marginal tax rate of 16%, the amount of tax deferral for *B* is \$201.60 (16% of \$1260 contribution). The percentage of tax deferral to compensation for *B* is therefore 1.34 ($\$201.60 \div \$15,000$). With a marginal tax rate of 18%, the amount of tax deferral for *C* is \$302.40 (18% of \$1680 contribution). The percentage of tax deferral to compensation for *C* is therefore 1.51 ($\$302.40 \div \$20,000$). With a marginal tax rate of 50%, the amount of tax deferral for *D* is \$6300 (50% of \$12,600 contribution). The percentage of tax deferral to compensation for *D* is therefore 4.2 ($\$6300 \div \$150,000$).

162. The percentage of tax deferral to compensation for *D*, 4.2, is 3.6, 3.1, and 2.8 times as great as those of *A*, *B*, and *C*, respectively.

163. The highest permissible integration level is the current taxable wage base, which (in 1983) is \$35,700. Rev. Rul. 71-446, §§ 6.01, 14.01, 1971-2 C.B. 187. However, a stated level such as \$20,000, which is below the highest permissible amount, may be used as the integration level. *Id.* The rate for contributions above the integration level is 5.4% more than the rate for contributions below the integration level (8.4% - 3%). The plan complies with the limits on contributions above the integration level since the 5.4% differential does not exceed the current (1983) OASDI tax rate (5.4%). I.R.C. § 401(1); Rev. Rul. 71-446, § 16, 1971-2 C.B. 187, 194 (Step-Rate Excess Plans).

tively.¹⁶⁴ The resulting percentages of tax deferral subsidy to compensation for *A*, *B*, *C*, and *D* are approximately .4, .5, .5, and 3.8, respectively.¹⁶⁵ Thus, the percentage of *D*'s salary that is subject to the tax deferral subsidy is seven to nine times as great as those percentages for the rank and file employees.¹⁶⁶ As a result of the use of the relatively moderate step-rate excess method of integration, the annual contribution for each of the rank and file employees is approximately one-third ($\$300 \div \840 , $\$450 \div \1260 , $\$600 \div \1680) of the contribution that would be made in their behalf had the plan not been integrated. In contrast, the annual contribution for *D* is approximately 91% of the contribution under the nonintegrated plan ($\$11,520 \div \$12,600$).

The hypothetical plans described above reveal a number of disturbing facts about the qualified plan subsidy. First, as previously discussed, the subsidy increases as the recipient's marginal tax bracket increases.¹⁶⁷ In other words, government assistance increases as the need for this assistance decreases. Second, integration compounds the already perverted allocation of this subsidy. Last, integration severely cuts into the retirement security that lower- and middle-income individuals can look to as a supplement to social security.

The principal justification for integration is that the skewing of the qualified plan system in favor of higher-paid individuals provides an appropriate counterbalance to the social security system's weighting of benefits in favor of lower-paid individuals.¹⁶⁸

164. The contribution for *A* is 3% of \$10,000, or \$300. The contribution for *B* is 3% of \$15,000, or \$450. The contribution for *C* is 3% of \$20,000, or \$600. The contribution for *D* is 3% of \$20,000 plus 8.4% of \$130,000 ($\$150,000 - \$20,000$), or \$11,520.

165. With a marginal tax rate of 14%, the amount of tax deferral for *A* is \$42 (14% of \$300 contribution). The percentage of tax deferral to compensation for *A* is therefore .42 ($\$42 \div \$10,000$). With a marginal tax rate of 16%, the amount of tax deferral for *B* is \$72 (16% of \$450 contribution). The percentage of tax deferral to compensation for *B* is therefore .48 ($\$72 \div \$15,000$). With a marginal tax rate of 18%, the amount of tax deferral for *C* is \$108 (18% of \$600 contribution). The percentage of tax deferral to compensation for *C* is therefore .54 ($\$108 \div \$20,000$). With a marginal tax rate of 50%, the amount of tax deferral for *D* is \$5760 (50% of \$11,520 contribution). The percentage of tax deferral to compensation for *D* is therefore 3.84 ($\$5760 \div \$150,000$).

166. *D*'s percentage of tax deferral to compensation, 3.84, is 7.1 times as great as that of *C* ($3.84 \div .54$), 8 times as great as that of *B* ($3.84 \div .48$), and 9.1 times as great as that of *A* ($3.84 \div .42$).

167. THE PRESIDENT'S 1978 TAX PROGRAM, *supra* note 128, at 2.

168. EMPLOYEE BENEFIT RESEARCH INSTITUTE [EBRI], PENSION INTEGRATION: CONCEPTS, ISSUES AND PROPOSALS 39-41 (1983).

This counterbalance, it is argued, results in the provision of something approaching equally proportionate retirement benefits for all employees.¹⁶⁹ Perhaps in some sort of conceptual vacuum, there may be a seductively logical charm to the proposition that each individual, regardless of the amount of his income, is entitled to the same percentage or proportion of retirement benefits. But when this proposition is applied in the context of governmentally subsidized programs whose purpose is to assist in providing retirement security, the result is absurd.

Social security places a ceiling on the amount of earnings (covered compensation)¹⁷⁰ to be taken into account in determining retirement benefits. Consequently, the payment of the same amount of benefits to two individuals—one whose average earnings equal covered compensation and the other whose average earnings exceed covered compensation—results in a greater percentage of wage replacement for the lower-compensated individual. Moreover, within the upper boundary set by covered compensation, there is a segmented benefit structure that provides a decreasing scale of benefits as average earnings increase.¹⁷¹ Thus, the ratio of benefits to average earnings is higher for an individual with \$5000 of average earnings than that for an individual with \$10,000 of average earnings.

The underlying premise of the social security benefit structure is that less financial assistance is required as disposable income and, with it, the ability to save increases.¹⁷² Like so many other governmental social welfare programs which are targeted at individuals who are in need of financial assistance in order to have adequate food, clothing, and shelter, there is a resulting redistribution of income from higher-income individuals to lower-income individuals. The extent of this aid is the subject of endless debate. But very few would argue that this aid should be provided on an equally proportionate basis to all income classes. Thus, although the government provides subsidized low-rent apartment housing to lower-income individuals, it would be nonsensical to provide subsidized low-rent mansions to higher-income individuals;¹⁷³ these in-

169. *Id.* at 6.

170. *See supra* notes 110 and 111.

171. McGILL, *supra* note 110, at 177.

172. *See* H.R. REP. No. 615, 74th Cong., 1st Sess. 147 (1935).

173. To the equally proportionate argument, Dianne Bennett responds:

dividuals do not need governmental assistance in this regard. Yet, the logic of the integration proponents would call for this result.¹⁷⁴

Given the accepted approach of social security to the payment of benefits, does it make any sense to try to counterbalance its distributional effect by using integration to severely skew qualified plan benefits in favor of the higher-paid? Surely, an employer and an employee have the right to agree as to how compensation will be paid for services rendered. Whether it is paid currently or on some deferred basis, no one—not the government or some academic—should have the right to dictate how that compensation should be paid. Thus, if an employer wants to increase the current or deferred compensation of higher-paid employees in order to balance out the social security benefit bias in favor of the lower-paid, the employer should and is free to do so. However, it is counterproductive for the government to provide a substantial subsidy as a bonus for this exercise of free enterprise. No governmental interest is served by providing financial assistance to those who do not need it. To the contrary, the government and its taxpayers are disserved by integration because it prevents the qualified plan from serving its logical purpose—affording supplemental retirement subsistence to those least able to provide it for themselves. The failure of the qualified plan to serve this role results in greater pressure being brought to bear on Congress to once again increase the benefits paid by the already overburdened social security system.

Some integration proponents concede that this process can result in the provision of relatively insignificant benefits for the lower paid.¹⁷⁵ They argue, however, that because social security provides adequate retirement benefits for lower and middle-income workers, qualified plans are not needed to supplement these work-

If we carried this argument to its logical extreme, we would have a tax benefit to balance every government program that expended monies on a particular income class. There would be a tax benefit for high paid persons' medical care because Medicare or Medicaid tend to favor lower-paid persons. There would be a tax benefit for high paid persons' use of cars and planes because government funds are expended on mass transit, which is used by lower-paid persons.

D. BENNETT, TYPED STATEMENT SUBMITTED TO PRESIDENT'S COMM'N ON PENSION POLICY, HEARINGS ON SOCIAL SECURITY INTEGRATION, S. REP. NO. 70, 96th Cong., 1st Sess. 4 (1979).

174. For arguments against the present integration rules but in favor of the concept of subsidized proportionate wage replacement, see Halperin, *Retirement Security and Tax Equity: An Evaluation of ERISA*, 17 B.C.L. REV. 739, 762-64 (1976).

175. EBRI, *supra* note 168, at 39.

ers' retirement incomes.¹⁷⁶ Since the only justifiable purpose of the retirement savings subsidy is to provide a dignified retirement subsistence for the typical low- and middle-income worker, there would be no justification for the qualified plan subsidy if social security already served this purpose.¹⁷⁷ However, most would concede that social security does not fulfill this need. Consequently, the qualified plan or some other savings system is necessary to provide the lower and middle-income worker with a meaningful supplement to the retirement benefits provided by social security.

Few would argue that, like social security, the qualified plan system should be skewed in favor of the rank and file. Notwithstanding the bias in favor of higher-paid employees that results from higher marginal tax brackets, few would argue against qualified plans providing proportional benefits to all employees with respect to a *modest level of compensation*, such as the median salary of American workers. But a subsidized qualified plan system that provides sizeable benefits to the higher-paid and, as a direct result of integration, merely trickles down relatively insignificant benefits for the rank and file, cannot be justified as a worthwhile governmental social program.

Another major argument for integration is that it prevents a lower-income worker from receiving combined social security and qualified plan benefits which exceed 100% of his pre-retirement income.¹⁷⁸ It should first be observed that, while theoretically possible, the "windfall" of over-100% combined benefits is, as a practical matter, a relatively rare occurrence for the lower-income worker.¹⁷⁹ Most of these individuals tend to be transient in terms of employment and, consequently, do not work long enough for one employer (e.g., 20 years) to accumulate a vested accrued benefit which, when aggregated with social security, would result in an over-100% combined benefit.¹⁸⁰

It is possible that some low-income individuals who have worked a considerable number of years for one employer with a nonintegrated qualified plan will experience over-100% combined benefits. However, because qualified plan benefits, unlike those of

176. *Id.*

177. THE PRESIDENT'S 1978 TAX PROGRAM, *supra* note 133, at 151.

178. EBRI, *supra* note 168, at 40-47.

179. BENNETT, *supra* note 173, at 4.

180. PRESIDENT'S COMM'N ON PENSION POLICY, *supra* note 1, at 28, 30-31.

social security, are rarely subject to post-retirement adjustments, inflation can quickly turn an over-100% combined benefit into an under-100% combined benefit.¹⁸¹ But, even assuming that combined benefits continue to exceed 100%, further inquiry should be made as to the role, if any, that the qualified plan has in this situation.

Many experts now agree that the amounts contributed by employers to qualified plans represent deferred wages for work performed by the employee.¹⁸² In other words, the employer is taking the qualified plan contribution into account in determining the overall amount of compensation that the employee's services warrant. Put yet another way, amounts set aside in a qualified plan on an employee's behalf are earned—employers in a private enterprise system are not in the habit of making gifts. Thus, it can hardly be argued that any benefits received from a qualified plan represent a windfall—they directly correspond to the quantity of work performed at particular skill levels.

If there is any culpability for the relatively rare over-100% combined benefit situation, it would have to be attributed to the social security system. In the various amendments of the social security laws, Congress has reaffirmed the policy of providing a substantially higher percentage of benefits with respect to the lower levels of pre-retirement income.¹⁸³ Seemingly, the over-100% benefit concern of the integration proponents could be more intelligently and efficiently addressed by the enactment of a new social security rule which would reduce social security benefits in the

181. BENNETT, *supra* note 173, at 4.

182. PRESIDENT'S COMM'N ON PENSION POLICY, *supra* note 1, at 30; EBRI, *supra* note 168, at 49. A related issue is whether the employer actually bears the cost of its Social Security contributions. A number of studies have concluded that employees ultimately pay most of the Social Security contributions indirectly; e.g., in lower wages and slower wage growth. *Id.* Moreover, attribution of 50% of the total Social Security benefit to an employer's contributions can be challenged on other grounds. Social Security is a pay-as-you-go system; i.e., benefits paid to retirees in the current year are derived from Social Security taxes paid by employees and their employers in the current year. Currently, the Social Security contributions of every three employees and their employers pay the Social Security benefits of a single retiree. PRESIDENT'S COMM'N ON PENSION POLICY, *supra* note 1, at 23-24, 28. This 3:1 ratio is projected to fall to 2:1 by the year 2035. *Id.* Since each retiree is being supported by several younger workers and their employers, it is argued that it is fallacious to attribute a certain percentage of the cost of a particular employee's future benefits to his present employer's contributions. EBRI, *supra* note 160, at 48-49.

183. D. MCGILL, *supra* note 110, at 11-12.

event that this situation arose. Instead of punishing all of the low- and middle-income individuals now subject to the integration rules, this social security rule would eradicate the problem at its source by reducing the benefits of those few low-income individuals who have over-100% combined benefits.

Perhaps the real crucible of integration is whether its consequences would be acceptable today in the context of a direct appropriated subsidy. There should be no doubt that if it was now considering the issue for the first time, Congress would refuse to grant a direct \$35-\$65 billion subsidy to encourage retirement savings where that subsidy would be allocated disproportionately to higher-income individuals and, in many cases, would provide negligible aid to lower- and middle-income individuals.

If Congress would reject the qualified plan subsidy in the form of a direct appropriated subsidy, why has it accepted this subsidy in the form of a tax expenditure? Unlike the hypothetical appropriation review described above, Congress is not dealing with a proposed subsidy; it is confronted by a longstanding and politically entrenched subsidy. The political strength and persuasiveness of those parties whose interests are served by integration are formidable. This was illustrated in 1974, when interested employers, banks, insurance companies, and actuaries orchestrated a last minute protest which succeeded in persuading Congress to overturn a conference-voted temporary freeze on the integration rules.¹⁸⁴ The protestors persuaded Congress that many qualified plans would terminate as a result of the temporary freeze. Undoubtedly, the prospect of a congressional repeal of integration would evoke an even more vehement protest.

As discussed in relation to lowered contribution and benefit limits, no real loss is suffered upon the termination of those qualified plans that were providing little or no benefits to the rank and file employees. Moreover, threats notwithstanding, many qualified plans would be continued because of the relative security that they provide in contrast to unfunded, nonqualified plans. However, more than a negligible number of qualified plans that currently provide some benefits for the rank and file would probably terminate as a result of the elimination of integration, particularly if this elimination is coupled with lowered contribution and benefit

184. See *supra* note 131.

limits. Again, the same quandry is presented: Should this tax subsidy be reduced and reallocated if, by doing so, it would cause many low- and middle-income qualified plan participants to lose the opportunity to earn any further retirement benefits?

It is submitted that the price of the present qualified plan system has risen to an unacceptable level. A nation suffering from \$200 billion deficits and rapidly decreasing respect for its tax laws cannot afford a \$35-\$65 billion retirement subsidy which provides disproportionately high benefits for executives and only meager benefits for many low- and middle-income workers. For those low- and middle-income workers who are suddenly left out in the cold, and for those who have always been out in the cold, a new retirement savings system must be devised.

IV. A NEW RETIREMENT SAVINGS SYSTEM

Approximately 50% of the private sector workforce is employed by companies which have never established a qualified plan.¹⁸⁵ Most of these uncovered individuals are lower- and middle-income workers.¹⁸⁶ Thus, social security serves as the only potential source of retirement security for the staggering number of lower- and middle-income workers who are presently uncovered and those who would join their ranks as a consequence of qualified plan terminations. These workers could set up their own IRA¹⁸⁷ accounts to which deductible contributions could be made. However, as previously discussed, individuals at the lower end of the disposable income scale have little ability and inclination to avail themselves of this tax-subsidized retirement device. As one would suspect, most of the IRAs have been established by high-income individuals.¹⁸⁸

The only solution to this problem lies in some form of minimum mandatory contribution for each employee. The idea of mandatory contributions is not novel. In the United States, the President's Commission on Pension Policy issued a report in 1981 which detailed the substantial gaps in coverage of the lower-paid and called for the institution of a mandatory contribution

185. PRESIDENT'S COMM'N ON PENSION POLICY, *supra* note 1, at 21-29.

186. *Id.*

187. *See supra* note 90.

188. PRESIDENT'S COMM'N ON PENSION POLICY, *supra* note 1, at 34-35.

system.¹⁸⁹

The exact specifications of a mandatory contribution system are the subjects of another article. However, certain suggestions as to the key elements can be made now. If the minimum contribution (e.g., 3 or 4%) was not being made to a qualified plan on an employee's behalf, the employer would be required to make that contribution either to an employer-administered fund or to a centralized fund administered by a governmental agency. An upper limitation (e.g., \$2000 — \$2500), subject to periodic cost of living increases, would be placed on the annual contribution that could be made for an employee. Each employee would have a separate 100% vested account reflecting the contributions and earnings thereon. The employer would deduct the contribution currently while the employee would exclude that amount from income. Taxation of the contributions and earnings thereon would be deferred to the time of distribution. In terms of the percentage of compensation that is being subsidized, the relatively low contribution limit would substantially narrow the gap that now exists between lower- and higher-income employees.¹⁹⁰

A number of facts about a mandatory system must be faced. Like employer contributions to already existing qualified plans, the cost of mandatory contributions would either be passed on to the consumer and/or serve to reduce the current compensation of the employee. It is likely that a significant part of these contributions would reduce current compensation. To that extent, we would be establishing a withholding system requiring employees to set aside some of their disposable income for retirement security. Consequently, we have yet another instance of government protection and bureaucratic regulation that many individuals would understandably resent during their pre-retirement years. But, when the alternative is considered—that of countless millions of individuals unable to subsist on social security during their retirement years—this forced savings program clearly becomes necessary. The

189. *Id.* at 42-52. In 1981, a hearing was held to discuss this report, but no further legislative action was taken. See REPORT OF THE PRESIDENT'S COMM'N ON PENSION POLICY: HEARING BEFORE THE SUBCOMM. ON SAVINGS, PENSIONS, & INVESTMENT POLICY OF THE SENATE COMM. ON FINANCE, 97th Cong., 1st Sess. (1981).

190. That gap could be eliminated in most cases by a somewhat more complicated tax credit provision. Under this provision, the employee would include the contribution in income, but would be entitled to claim a refundable tax credit equal to 20-25% of the amount of that contribution.

formulation and implementation of such a program should not be delayed.

CONCLUSION

The only justifiable purpose of the extraordinarily large qualified plan tax subsidy is to provide the rank and file with an adequate retirement income supplement to that provided by social security. Yet, as a result of high contribution and benefit limits and integration with social security, the current qualified plan system provides lavish retirement benefits to the higher-paid, while at the same time depriving many rank and file of any meaningful retirement security. Therefore, in order to attain a more rational and humane allocation of this subsidy, the qualified plan rules should be changed so that integration would be eliminated and the contribution and benefit limits would be lowered to median-income levels. These changes would not impinge upon the rights of higher-paid employees to amass large amounts of retirement savings. However, they would reduce appropriately the extent to which this country subsidizes these savings.

Some qualified plans would terminate as a result of these changes. For those rank and file who lose coverage as a result of qualified plan terminations, and, more importantly, for those rank and file who have never been covered, a mandatory minimum contribution system should be instituted in order to assure these individuals of an adequate retirement subsistence.