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Cross-Tested Defined Contribution Plans: A Response to Professor Zelinsky

PETER ORSZAG[†] AND NORMAN STEIN^{††}

Section 401(a)(4) of the Internal Revenue Code denies favorable tax treatment to pension and profit-sharing plans whose contributions or benefits discriminate in favor of highly compensated employees. The traditional approach to testing a defined contribution plan for such discrimination is to compare the contributions allocated to the accounts of rank-and-file employees to those allocated to the accounts of highly compensated employees. Under this approach, a plan impermissibly favors highly compensated employees if such employees receive, as a percentage of pay, greater contributions than rank-and-file employees.¹ For example, an employer who contributed 15% of the pay of highly compensated employees would also have to contribute at least 15% of the pay of non-highly compensated employees.

In the early 1990s, the Department of Treasury promulgated regulations that endorsed a different means of testing defined contribution plans for discrimination.² Instead of testing such plans for discrimination on a contributions basis, the regulations endorsed testing on a benefits basis, a method at one time extended to defined contribution plans in only a limited number of situations.³ Testing a defined contribution plan on a benefits basis requires conversion of each annual contribution into a single life annuity commencing when the employee attains

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1. In practice, however, firms have the ability to provide substantially higher contribution rates for higher-paid employees, even apart from cross-testing of defined contribution plans. We discuss some of the tools firms can use to effect such discrimination *infra* Part I.B.

2. See Treas. Reg. § 1.401(a)(4)-8 (as amended in 1993).

3. See Rev. Rul. 70-580, 1970-2 C.B. 90. See *infra* text accompanying notes 47-50.

age sixty-five.⁴ The resulting annuity benefits for highly compensated and rank-and-file employees are then compared as a percentage of current pay. Because the power of compound interest operates between the year of contribution and the year the employee attains age sixty-five, the younger the employee the smaller the amount of firm contribution to the plan needed to produce a dollar annuity at age sixty-five. Thus, cross-testing permits a firm to make a much larger contribution for an older employee than for a younger employee.⁵

Cross-testing therefore offers firms a method for making larger contributions for highly paid employees, so long as they are older than other employees participating in a plan.⁶ Some firms have undertaken variations of cross-tested plans that exploit certain technical rules relating to plan participation and nondiscrimination testing in order to: (i) increase dramatically the amount of disparity between older and younger employees; (ii) deprive older rank-and-file employees the larger benefits that cross-testing permits for older highly compensated employees; and (iii) provide significant benefits for younger highly compensated employees despite the use of cross-testing to limit benefits for other young employees. These second-generation cross-tested arrangements combine numerous benefit formulas, use aggressive testing methodologies, and require complex calculations unlikely to be understood by

4. See Treas. Reg. § 1.401(a)(4)-8(b).

5. We discuss this methodology, with examples, in more detail *infra* Part I.C.

6. Shortly after firms began exploiting the regulations' endorsement of cross-testing, the Clinton Administration asked Congress to outlaw the practice. Industry lobbyists succeeded in removing cross-testing limitations from the legislation ultimately enacted. See, e.g., *GATT Passage Gives Go-Ahead to Long-Sought Pension Reforms*, 21 Pens. & Ben. Rep. (BNA) 2259 (Dec. 5, 1994); *Actuaries to Continue Federal Pension Audits*, 21 Pens. & Ben. Rep. (BNA) 2014 (Oct. 24, 1994); *Pension Reforms in Trade Bill Represent Employer Victory, Aide Says*, 21 Pens. & Ben. Rep. (BNA) 1847 (Oct. 3, 1994); *Administration Pension Reform Bill Clears Education and Labor Committee*, 21 Pens. & Ben. Rep. (BNA) 1563 (Aug. 15, 1994); *Archer Calls for Government Scrutiny of Every Increase in Pension Benefits*, 21 Pens. & Ben. Rep. (BNA) 814 (Apr. 25, 1994); *PBGC Bill Likely to Move Forward, April Hearings Planned*, 21 Pens. & Ben. Rep. (BNA) 645 (Mar. 28, 1994); *Administration's Reform Package Introduced by Reps. Ford, Rostenkowski*, 20 Pens. & Ben. Rep. (BNA) 2297 (Nov. 1, 1993); *Several Pension Related Issues Left on This Year's Legislative Agenda*, 20 Pens. & Ben. Rep. (BNA) 1965 (Sept. 20, 1993).

either firm managers or employees. They are often referred to as "new comparability" plans.

The Department of Treasury has recently proposed to restrict the use of certain second-generation cross-tested plans.⁷ In particular, the proposed regulations would in some cases require higher minimum contributions for rank-and-file workers than would otherwise be the case.⁸

Edward Zelinsky argues that the proposed Treasury regulations are a misguided intermediate step to control cross-testing.⁹ Professor Zelinsky believes that cross testing should be universally permitted as a matter of policy, and that cross-testing and the proposed regulations highlight fundamental flaws and inconsistencies in the nondiscrimination rules more generally. As a result, Professor Zelinsky would either eliminate the nondiscrimination rules altogether or substitute a simpler nondiscrimination principle based on universal minimum contributions for all employees. This paper offers a response to Professor Zelinsky.¹⁰

We agree with Professor Zelinsky that the proposed regulations constitute an awkward intermediate step between accepting and rejecting cross-testing. But unlike Professor Zelinsky, we respond to such awkwardness by concluding that cross-testing should be generally, if not universally, prohibited. From our perspective, the regulations are a beneficial, albeit limited, first step on the road to eliminating most cross-testing. Moreover, we make

7. See Prop. Treas. Reg. § 1.401(a)(4)-8(b), 65 Fed. Reg. 59,777 (Oct. 6, 2000); Prop. Treas. Reg. § 1.401-(a)(4)-9(b)(2)(v), 65 Fed. Reg. 59,779 (Oct. 6, 2000); see also IRS Notice 2000-14, 2000-1 CB 737 (seeking public comments for IRS and Treasury review of new comparability plans).

8. See Prop. Treas. Reg. § 1.401(a)(4)-8(b)(1)(4), 65 Fed. Reg. 59,777; Prop. Treas. Reg. § 1.401(a)(4)-9(b)(2)(v)(d), 65 Fed. Reg. 59,779.

9. Edward A. Zelinsky, *Is Cross-Testing A Mistake? Cash Balance Plans, New Comparability Formulas, and the Incoherence of the Nondiscrimination Norm*, 49 BUFF. L. REV. 575 (2001) [hereinafter Zelinsky, *Is Cross-Testing A Mistake?*].

10. We do not respond to Professor Zelinsky's comments on cash balance plans, a type of plan which he believes is impermissible as a matter of law, but supportable as a matter of tax and retirement policy. See Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683, 684 (2000) [hereinafter Zelinsky, *The Cash Balance Controversy*]. One of us has written on the subject of cash balance plans and suggested that conversions of existing defined benefit plans to cash-balance plans are problematic because of their effect on the expectations of long-tenured older employees. See Norman Stein, *Some Serious Questions About Cash Balance Plans*, CONTINGENCIES, Sept.-Oct. 1999, at 28.

an additional argument: that defined benefit plans, which historically have been tested on a benefits rather than contribution basis,¹¹ be limited to situations in which the firm is not using the plan principally to direct benefits to older highly compensated employees.¹²

We also find ourselves in agreement with Professor Zelinsky that the current nondiscrimination rules poorly bear the weight of the rules' complexity and the ability of sophisticated pension planners to exploit that complexity to tilt the benefits of plans to the advantage of favored highly paid employees. We would thus agree with Professor Zelinsky that it may be desirable to replace the current nondiscrimination rules with a simpler and more effective regulatory approach.

The first section of the paper provides background on the cross-testing rules. The second section summarizes Professor Zelinsky's argument. The third section analyzes and critiques that argument. The fourth section considers cross-testing in the context of legislation that would (i) increase qualified plan contribution and benefit limits, and (ii) relax nondiscrimination principles.¹³ The fifth section examines the recently proposed Treasury regulations.¹⁴ We conclude by discussing a broader set of reforms to the nondiscrimination rules.

11. This is, of course, the "natural" means of nondiscrimination testing for a plan that provides participants with retirement annuities under a plan formula rather than a benefit equal to an account balance.

12. Cf. Norman Stein, *Some Policy Implications of the IRS' Small Defined Benefit Plan Audit Program*, 55 TAX NOTES 1407, 1410-11 (1992) (arguing that the Internal Revenue Code should not extend qualified tax status to most defined benefit plans of small firms, since such plans are generally regarded by the firm's owners as the equivalent of defined contribution plans). For a thought-provoking discussion of when benefits testing may be appropriate in a world of hybrid plans, see Daniel Halperin & Marla Schnall, *Regulating Tax Qualified Pension Plans in a Hybrid World*, 58 N.Y.U. INST. FED. TAX'N, at 5-1 (2000).

13. [Editor's Note: A version of the legislation discussed *infra* Part IV was enacted by Congress as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 (2001), in June 2001, after this article went into production.]

14. [Editor's Note: The Proposed Regulations discussed *infra* Part V have been adopted with modifications. See 66 Fed. Reg. 34,535 (June 29, 2001).]

I. BACKGROUND ON CROSS-TESTING AND THE NONDISCRIMINATION NORM

In this section, we review briefly the history, theory and operation of the nondiscrimination rules generally, and cross-testing in particular.

A. *Historical Overview*

Prior to 1942, the Internal Revenue Code required only that pension plans benefit all or some employees of a firm.¹⁵ Some firms accordingly adopted plans whose coverage was limited to a small number of shareholders and highly paid managers.¹⁶ The Department of Treasury regarded these plans as little more than tax shelters serving no social purpose and proposed a variety of requirements for employee deferred compensation plans, including nondiscrimination rules. In 1942, Congress responded to Treasury's concerns by enacting two related sets of nondiscrimination rules: minimum coverage rules, requiring plans to cover at least some rank-and-file workers, and benefit and contribution nondiscrimination rules, requiring that covered rank-and-file employees receive either benefits or contributions comparable, as a percentage of pay, to the benefits or contributions of officers, shareholders and other highly compensated employees.

There are three ways of viewing the Treasury proposals and Congress's intent in adopting them: first, as a means of curtailing the use of pension plans as tax shelters covering only key employees (Treasury wanted to limit the tax abuse it found inherent in an employee retirement plan covering only key employees); second, as a means of reserving a tax subsidy for plans that provide some social benefit; and third, as a means of affirmatively encouraging the

15. See Revenue Act of 1926, Pub. L. No. 69-20, § 219(f), 44 Stat. 9, 33-34 (1926); Internal Revenue Code of 1939, Pub. L. No. 76-1, § 165, 53 Stat. 67 (1939).

16. See George T. Altman, *Pension Trusts for Key Men*, TAX MAG., June, 1937, at 324. Two cases before the Board of Tax Appeals approved plans that provided benefits only to a group of highly paid individuals. See *Moore v. Comm'r*, 45 B.T.A. 1073 (1941); *Harris v. Comm'r*, B.T.A.M. (P-H) 39,472 (1939).

formation of pension plans that provide such benefits.¹⁷ Historical evidence exists to support each of these views. Indeed, some of the historical debate is not over which view is correct, but rather over which view predominated policy thought in 1942.¹⁸

All three views continue to provide perspective for discussion of pension and tax policy, although we believe that today the third idea is understood more in terms of trying to effect broad pension coverage in the general population, especially of rank-and-file employees who are unlikely to save adequately for retirement on their own. For example, the report of the House Ways and Means Committee on the 1986 Tax Reform Act, the most significant tax legislation in the last half-century, observed that the purpose of the nondiscrimination rules is to "ensur[e] that tax-favored qualified plans provide benefits for low- and middle-income employees who otherwise might not have reasonable retirement savings."¹⁹

B. *Operation of Nondiscrimination Rules and Limitations on Their Effectiveness*

As we earlier observed, the traditional understanding of the nondiscrimination rules was that they required defined contribution plans to be tested on a contributions basis, with the plan considered nondiscriminatory so long as contributions for both rank-and-file employees and highly paid employees reflected the same percentage of compensation. Thus, for example, a firm's defined contribution plan would satisfy the nondiscrimination rules if in a given year the firm contributed \$1000 for an employee with \$10,000 of compensation and \$10,000 for an employee earning \$100,000.

Defined benefit plans, on the other hand, were tested on a benefits basis by comparing, as a percentage of pay, the

17. See Norman P. Stein, *Some Lessons from History: The Origins of Pension and Profit-Sharing Taxation, 1914-1942*, 58 N.Y.U. INST. FED. TAX'N, at 12-1 (2000); Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 433 (1987); Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063, 1144-51 (1997).

18. See Stein, *supra* note 17, at 12-40.

19. H.R. REP. NO. 99-426, at 711 (1985).

projected annuity benefits at retirement age of rank-and-file and highly compensated employees. Thus, for example, a plan that provided an employee with a retirement annuity equal to 1% of average (or final) pay multiplied by years of service would satisfy the nondiscrimination requirements since all participants would receive a benefit based on the same percentage of their individual compensation.

The nondiscrimination rules do not, however, mandate that firms provide the type of proportional benefits that the nondiscrimination principles nominally require. There are a number of reasons for this divergence from proportionality, including the Code's coverage rules,²⁰ special rules "integrating" private plan benefits with Social Security,²¹ and planning devices that use facially neutral rules to exploit tenure and demographic distinctions between a firm's rank-and-file and highly compensated employees.²² We describe five important tools (other than cross-testing) that firms sometimes use to achieve discrimination among these two groups of employees. We also describe the "top-heavy" rules, which Congress adopted to direct greater benefits toward rank-and-file employees in plans that are heavily weighted to officers, owners and relatively highly paid employees.²³

1. *Social Security Integration ("Permitted Disparity")*. The Internal Revenue Code permits firms sponsoring defined contribution plans to provide higher contribution rates for compensation above the Social Security taxable wage base;²⁴ firms sponsoring defined benefit plans can provide larger benefit accrual rates for benefits above the wage base or can reduce benefits by a percentage of Social Security benefits.²⁵

20. See I.R.C. § 401(a)(3) (1994), as amended by Pub. L. No. 106-554, 114 Stat. 2763 (2000); I.R.C. § 410(b) (1994).

21. I.R.C. § 401(l) (1994).

22. For example, a firm can provide a minimum employment period before a plan participant attains a nonforfeitable right to their accrued benefits. See *id.* § 411 (1994 & Supp. III 1997) (prescribing minimum vesting standards). Such minimum periods will sometimes favor highly paid employees, who generally have longer tenures with a particular firm and thus are more likely to vest in their benefits.

23. See generally *id.* § 416 (1994 & Supp. II 1996).

24. Rev. Rul. 2000-53, 2000-47 I.R.B. 488 (2000) (\$80,400 in 2001).

25. See generally I.R.C. § 401(l) (1994) (outlining social security integration standards); Treas. Reg. § 1.401(a)(4)-7 (as amended in 1993) (describing how to

2. *Coverage Rules.* A plan meets the minimum coverage rules by satisfying one of two alternative tests.²⁶ The first test is called the ratio percentage test.²⁷ Under this test, the firm calculates a plan's percentage coverage of highly compensated employees. The plan must then cover at least 70% of that percentage among rank-and-file employees.²⁸ Thus, if a plan covers 100% of the highly compensated employees, it must also cover at least 70% of the non-highly compensated employees. In other words, this test permits a firm to cover all of a firm's highly compensated employees and deny coverage to 30% of the other employees, or to cover some lesser but proportionate percentage of both sets of employees.²⁹

If a plan does not pass the ratio percentage test, it may still pass the average benefit test. Under this rule, the plan must include and exclude employees under a reasonable business classification system adopted by the firm.³⁰ The firm next must show that the classification is

impute these standards when benefit formula does not explicitly incorporate statutory formal requirements). For two excellent critiques of the Social Security integration requirements, see Altman, *supra* note 17 and Dilley, *supra* note 17.

26. See I.R.C. § 410(b)(1)-(2) (1994).

27. See *id.* § 410(b)(1)(B); Treas. Reg. § 1.410(b)-2(b)(2) (as amended in 1994). The Code also includes a third alternative, which simply provides that an employer's plan cover at least 70% of all non-highly compensated employees, see I.R.C. § 410(b)(1), but such a plan will also always satisfy the ratio percentage test, since the firm cannot cover more than 100% of the highly compensated employees, at least under the rules of math as we understand them.

28. Certain employees are not counted in applying the coverage tests, and certain other employees may be excluded at the election of the firm. See I.R.C. § 410(b)(3)-(4) (1994).

29. Thus, for example, a plan that covered 50% of the highly compensated employees would need to cover 35% of the non-highly compensated employees.

30. See *id.* § 410(b)(2)(A)(i). The statute provides that the plan must benefit "such employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated employees." *Id.* The regulations, in turn, require that the classification be both "reasonable" and "nondiscriminatory." See Treas. Reg. § 1.410(b)-4 (as amended in 1992). For a classification to be "reasonable" it must be one

established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salary or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification.

Id. § 1.410(b)-4(b).

nondiscriminatory, which involves applying a weaker version of the ratio percentage test, where the ratio of the general test is reduced to as low as 20%, depending on the concentration of non-highly compensated employees in the workforce.³¹ The final component of the average benefit test requires that the average benefit of the rank-and-file employees, as a percentage of pay, is at least 70% of the average benefit of the highly compensated employees.³² Thus, this test expressly contemplates a substantially lower rate of benefits (as a percentage of pay) for rank-and-file employees. Firms can also game both the ratio percentage and average benefits tests by including in their plans the lowest paid rank-and-file employees, and/or providing high rates of benefits (as a percentage of pay) for the least well paid of the non-highly compensated employees.³³ Moreover, average benefits under this test are calculated after adjusting for Social Security integration.³⁴

Moreover, the nondiscrimination regulations permit a plan to be divided into what amounts to sub-plans created for each of the allocation or benefit rates of each highly compensated employee. These sub-plans, which are referred to as rate groups, are then tested individually for

31. See Treas. Reg. § 1.410(b)-4(c). The regulations provide both a "safe harbor" ratio percentage and an "unsafe harbor" ratio percentage. See *id.* § 1.410(b)-4(c)(4)(i)-(ii). The classification is deemed automatically nondiscriminatory if it tests within the safe harbor percentage and discriminatory if it tests in the unsafe harbor. See *id.* § 1.410(b)-4(c)(1)-(2). If the classification tests between the two harbors, the plan must demonstrate on a facts-and-circumstances basis that the classification is nondiscriminatory. *Id.* § 1.410(b)-4(c)(3). The regulations provide certain relevant facts and circumstances, including the underlying purpose of the business classification and the overall percentage of employees benefiting under the plan. See *id.* § 1.410(b)-4(c)(3)(ii). The safe harbor percentage is as high as 50% for workforces in which no more than 60% of the workforce is non-highly compensated, and drops as low as 20.75% when 99% of the workforce is non-highly compensated. See *id.* § 1.410(b)-4(c)(4)(iv).

32. I.R.C. § 410(b) (1994). The percentage is based on an employee's participation in all plans of the employer. *Id.* § 410(b)(2)(C)(i). All employees of the employer, except for certain statutorily excluded and excludable employees, see *id.* § 410(b)(3)-(4), are taken into consideration in applying the average benefits component of the test, including those employees who do not participate in any plan of the employer. *Id.* § 410(b)(2)(B), (D).

33. Under the average benefit test, the average is computed as the mean of the benefit rates among each class of worker, not as overall benefits divided by overall compensation for each class of worker. See *id.* § 410(b)(2)(B)-(C). In other words, the average is computed without weighting by compensation.

34. See Treas. Reg. § 1.410(b)-5(d)(6) (as amended in 1993).

compliance with the minimum coverage tests. If all of the rate groups would satisfy the minimum coverage test, then the overall plan is deemed nondiscriminatory in benefits or contributions.

3. *Forfeitures for Short Tenures.* A firm may design a plan that conditions benefit receipt on the employee achieving a specified minimum tenure with the firm. The Internal Revenue Code constrains firms in the design of such forfeiture conditions; under current law, firms generally may require no more than five years of service before benefits become nonforfeitable.³⁵ In some firms, however, the distribution of completed job tenures is substantially more skewed toward shorter tenures among rank-and-file employees than among highly compensated employees. In such firms, a much smaller percentage of rank-and-file workers than highly compensated employees will achieve nonforfeitable benefit rights.

4. *Providing Past Service Credits and Retroactive Benefit Increases.* When a firm adopts a defined benefit plan, it can credit participants with benefit credits for service prior to the time the plan was adopted. Similarly, a firm is permitted to amend an existing defined benefit plan to improve the plan's benefit formula, and the enhanced benefit formula may, at the firm's option, apply to credits based on earlier years of service. The firm's highly compensated employees will disproportionately benefit from such credits if their job tenures tend to be longer than those of rank-and-file workers. Smaller firms would presumably award past-service credit when their highly compensated employees would disproportionately benefit from such credits. To limit such abuses, the regulations limit past-service credits in certain circumstances in which they would be discriminatory.³⁶ Some discrimination is still possible, since the regulations also include safe harbors allowing five

35. See I.R.C. § 411(a)(2)(A) (1994 & Supp. II 1996). A firm may instead use a graded vesting schedule, under which employees must vest in at least 20% of their benefits after three years of service, 40% after four years, and so on until they become 100% vested after seven years of service. See *id.* § 411(a)(2)(B). Top-heavy plans are subject to steeper minimum vesting standards. See *infra* text accompanying notes 41-45.

36. See Treas. Reg. § 1.401(a)(4)-5(a)-(b) (as amended in 1993).

years of past-service credit without regard to its discriminatory effects.³⁷

5. *Choice of Plan Format.* Even before firms were permitted to use cross-testing to satisfy the defined contribution nondiscrimination rules, they were able to award benefits with greater present values (relative to current compensation) to older employees through the adoption of either a traditional defined benefit plan³⁸ or a target benefit defined contribution plan.³⁹ Thus, if a firm's higher paid employees were older than its rank-and-file workers, the firm could favor the higher paid workers through the adoption of one of these types of plans. Moreover, a firm that adopted a defined benefit plan format could in many circumstances further skew benefits toward older, favored employees through adoption of either the fractional or the 3% accrual methods, both permitted by the Internal Revenue Code.⁴⁰

37. *Id.* § 1.401(a)(4)-5(a)(3).

38. Defined benefit plans favor older employees principally because these plans are normally tested on a benefits basis; a dollar contribution to a plan buys a larger retirement age annuity for an older employee because of the time value of money. In addition, defined benefit plans can base the annuity on an employee's final compensation, *see supra* note 8, which will favor an employee who reaches retirement age at the firm sponsoring the plan. For a discussion of why traditional defined benefit formulas favor older employees, see Norman P. Stein, *Simplification and IRC § 415*, 2 FLA. TAX REV. 69, 79-81 (1994) [hereinafter Stein, *Simplification and IRC § 415*].

39. Target benefit plans are money-purchase defined contribution plans that set contributions at a rate designed to create a plan account sufficient to purchase a targeted lifetime annuity benefit. Target benefit plans are, then, an early form of cross-tested plan. However, the contributions under the plan had to be based on a particular funding method—the level premium funding method—which produced a lower age-weighted disparity in contribution levels than did defined contribution plans cross-tested under the testing methodology permitted in Treas. Reg. § 1.401(a)(4)-8 (as amended in 1993). *See* Rev. Rul. 76-464, 1976-2 C.B. 115. *See generally* Labh S. Hira & Paul Perry, *Target Benefit Plans: An Appealing Option for Small Employers*, TAX ADVISER, Jan. 1987, at 330.

40. Defined benefit formulas have to conform to one of three sets of accrual standards. One standard, the fractional rule, permits a plan to provide a flat benefit at retirement age (for example, 100% of final pay) and multiply it by a fraction, the numerator of which is an employee's years of actual plan participation, and the denominator of which is the participant's projected years of plan participation through normal retirement age. *See* I.R.C. § 411(b)(1)(C) (1994). Thus, a fifty-five year old lawyer would accrue 10% of the plan's flat benefit per year, but her twenty-five year old secretary would accrue only 4% of

The effect of these tools can be to substantially skew benefits in favor of highly compensated employees, particularly in smaller firms. In reaction to this reality, Congress created the concept of a plan becoming top-heavy,⁴¹ which occurs when at least 60% of the benefits under the plan are for "key employees."⁴² If a plan is top-heavy, it is subject to rules intended to ameliorate this weighting of benefits: shorter maximum vesting periods⁴³ and a minimum benefit requirement for rank-and-file employees in favor of such employees.⁴⁴ In the case of a defined contribution plan, the minimum benefit is a contribution equal to 3% of compensation.⁴⁵

his benefit per year, because the lawyer has only ten years until attaining retirement age while the secretary has forty. Moreover, if the plan terminates when the lawyer attains age sixty-five, as is likely, the secretary will not have a chance to earn his full benefit. The 1993 nondiscrimination regulations limit the extent of discrimination that could be effected through the fractional rule, but include safe harbors, one of which permits use of the fractional rule so long as the denominator of the fraction is not less than twenty-five for each participant. See Treas. Reg. § 1.401(a)(4)-3(b)(4) (as amended in 1993).

Another accrual method, the 3% rule, could also be used to devote additional pension resources toward higher earners. The rule, which requires that in any given year a participant has accrued a benefit equal to at least 3% of the largest benefit under the plan, would permit the use of the following benefit formula: during the first nine years of plan participation, a participant accrues a benefit equal to 3% of pay, and in the tenth year a benefit equal to 73% of pay. So long as a fifty-five year old business owner does not employ an employee for the ten year period between plan adoption and retirement, the formula can effect a substantial degree of discrimination in the last year of the plan, assuming the plan will be terminated when the owner attains age sixty-five. This aggressively discriminatory use of the 3% rule has also been curbed by the nondiscrimination regulations. See Treas. Reg. § 1.401(a)(4)-3.

41. See I.R.C. § 416(g) (1994 & Supp. II 1996).

42. See *id.* § 416(g)(1)(A). The term "key employee" is designed to identify employees with a proprietary interest in the firm and thus is both broader and narrower than the term "highly compensated employee," which is primarily focused on employees with compensation exceeding a threshold level. Compare *id.* § 416(i)(1) ("key employee" includes ten highest paid employees, certain officers, and certain owners) with *id.* § 416(q) (1994) ("highly compensated employee" includes any employee who received compensation in excess of \$80,000 (as indexed for inflation, currently \$85,000, I.R.S. News Release IR-99-80 (Oct. 19, 1999)), or who falls within the top 20% of employees ranked on the basis of compensation paid, as well as certain owners).

43. See I.R.C. § 416(b) (1994). Section 416(b) substitutes a three year cliff vesting rule for the otherwise applicable five year cliff vesting rule, see I.R.C. § 411(a)(2)(A) (1994 & Supp. II 1996), and a six year graded vesting rule for the otherwise applicable seven year graded vesting rule. *Id.* § 411(a)(2)(B).

44. See *id.* § 416(c) (1994).

45. *Id.* § 416(c)(2)(A). The top-heavy rules originally contained a

C. Background on Cross-Testing

Since 1942, the Code has required nondiscrimination in “the contributions or benefits” of qualified plans.⁴⁶ The original understanding of this provision was that defined contribution plans were tested on the basis of contributions and defined benefit plans on the basis of benefits. It is clear that at least through 1970, and possibly through most of the 1980s, the IRS did not permit cross-testing of either a stand-alone defined contribution plan or a group of two or more defined contribution plans for minimum coverage as if they were a single plan.⁴⁷

The idea of cross-testing was created for a special situation: when a firm aggregated a defined contribution plan with a defined benefit plan. Such situations required a methodology in which the benefits in one plan could be compared with the contributions in the other. The IRS responded to this need with a series of revenue rulings, which provided a means for testing the aggregated plans on either a benefits or contributions basis.⁴⁸ A 1970 ruling limited the methodology to aggregations of defined benefit and defined contribution plans, stating that “the test for

modification of I.R.C. § 415(e), which limited the extent to which an employer could make maximum contributions to a defined contribution plan and also provide a maximum annuity benefit under I.R.C. § 415(c) and (b), respectively. I.R.C. § 415(e) was repealed by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, Title I § 1452(a), 100 Stat. 1816 (1996). For a description of former § 415(e), see Stein, *Simplification and IRC § 415*, *supra* note 38, at 73-76.

46. See Revenue Act of 1942, Pub. L. No. 77-753, § 162(a), 56 Stat. 798, 862-63 (1942); I.R.C. § 401(a)(4) (1994).

47. See Rev. Rule 70-580, 1970-2 C.B. 90. However, Brian A. Graff, the Executive Director of the American Society of Pension Actuaries, has written that “[s]ince 1981, Treasury and IRS guidance has permitted qualified plans to satisfy the Code’s nondiscrimination requirements by effectively comparing contributions under a defined contribution plan to the benefits that would be received under a defined benefit plan.” BRIAN GRAFF, SMALL BUSINESS RETIREMENT PLANS WILL TERMINATE DUE TO POTENTIAL TREASURY CHANGES TO QUALIFIED PLAN REGULATIONS: MORE TIME IS NEEDED TO STUDY THE ISSUE (2000), <http://www.aspa.org/archivepages/gac/2000/newcomppaper.htm>. In a phone conversation with one of the authors of this article, Mr. Graff indicated that no written formal guidance permitting cross-testing of stand-alone plans existed, but that the practice was permitted by at least some IRS regional offices.

48. See Rev. Rul. 70-580, 1970-2 C.B. 90; Rev. Rul. 74-165, 1974-1 C.B. 96; Rev. Rul. 74-166, 1974-1 C.B. 97; Rev. Rul. 81-202, 1981 C.B. 70; Rev. Rul. 83-110, 1983-2 C.B. 70.

discrimination in this case is made with respect to contributions since a money purchase pension plan and a profit sharing plan are involved."⁴⁹

It was not until 1993 that the IRS explicitly approved a methodology that could be used not only for testing aggregated defined benefit and defined contribution plans, but also for testing single defined contribution plans or aggregations of two defined contribution plans.⁵⁰ The methodology became, in essence, a safe harbor for testing single or aggregated defined contribution plans on a benefits basis.

We turn now to an illustration of how a small firm can use cross-testing to disproportionately favor a highly compensated employee. Consider a firm with one older, high-earning owner and several younger, lower-paid workers, all earning less than the social security wage base.⁵¹ The firm has a defined contribution pension plan that covers the older owner and all of the younger, lower-paid workers. Assuming the plan were integrated with social security, the firm could set a higher contribution rate (up to 5.7% higher) for earnings above the maximum Social Security taxable wage base than below it without violating the nondiscrimination rules. Such a differential contribution rate would benefit only the highly compensated employee.

Under cross-testing, however, the firm could direct still additional pension contributions to the older owner. Cross-testing allows the defined contribution plan to be tested in terms of the hypothetical retirement benefits projected for each worker (which is the general nondiscrimination test for defined benefit plans) rather than the amount of the actual contribution made on behalf of each worker (the general nondiscrimination test for defined contribution plans).⁵² The longer the number of years before retirement during which any given contribution earns interest (and benefits from the power of compound interest), the larger the hypothetical retirement benefit from any given contribution.

49. Rev. Rul. 70-580, 1970-2 C.B. 90.

50. See Treas. Reg. § 1.401(a)(4)-8 (as amended in 1993).

51. Our example reflects the year 2000 limit of \$30,000 for additions to a defined contribution account; in 2001 the limitation, which is indexed to the cost of living, is \$35,000. See I.R.C. § 415(c) (1994 & Supp. II 1996).

52. See Treas. Reg. § 1.401(a)(4)-8.

Since younger workers have more years until retirement than older workers, \$1 put into the account of a younger worker produces a larger hypothetical retirement benefit than \$1 put into the account of an older worker. Therefore, if the testing is done on the basis of the hypothetical retirement benefits that ultimately can be paid from the contributions, rather than on the basis of the actual contributions themselves, the contributions the employer makes on behalf of the younger workers can be substantially lower than the contributions the employer makes on behalf of the older workers. For example, if the firm applies a projected return of 8.5% per year to compute hypothetical retirement benefits, and if the owner is sixty years old while the younger workers are all twenty-one years old, the contribution rate for the sixty year old owner can be *twenty or more times larger* than the average contribution rate for twenty-one year old workers without causing the employer to fail to meet the nondiscrimination test.⁵³

The first generation of defined contribution cross-tested plans used the relationship between age and projected retirement benefits to skew contributions toward older owners. But the pension industry has recently created new versions of cross-tested plans that allow even more skewing toward high-income workers. These plans, often called “new comparability” plans, provide higher benefits only to specific favored older employees (for example, older owners), while providing much smaller benefits to other older employees.⁵⁴ One pension firm, whose Web site claims

53. For example, assume the contribution rate on behalf of all the younger twenty-one year old workers is 1% (i.e., the contribution is equal to 1% of compensation for each worker). Given 8.5% annual growth over the forty-four years between age twenty-one and age sixty-five, each worker's account balance from that contribution would grow to 36.2% of current compensation. Since the projected retirement benefits are directly proportional to this accumulated balance, the older owner can therefore receive a contribution that would grow to 36.2% of current compensation. A current contribution of 24.1% of compensation would accumulate to 36.2% after five years. Therefore, the contribution rate for the owner could be as high as 24.1% of current compensation while the younger worker received pension contributions equal to only 1% of compensation. This example assumes that the plan is not subject to the top-heavy rules.

54. The terminology used to describe these plans is sometimes confusing: Some pension experts refer to the first generation of cross-tested plans as “age-weighted” and refer to new comparability plans as “cross-tested.” A related

that it pioneered the new comparability approach, advertises that the “plan design allows contributions up to \$30,000 for senior executives without raising the contribution for the other employees.”⁵⁵ Similarly, an article in *Physician’s News Digest* noted that “[w]hen used aggressively, new comparability cross-testing enables physicians to maximize their retirement plan contributions while at the same time reducing the total contribution for the year.”⁵⁶

Under the first generation of cross-tested plans, all older employees would benefit from the tilting of contributions toward older workers, while a younger owner would get little from the cross-tested pension plan. Under a new comparability plan, the firm can make relatively large contributions on behalf of an older owner *and* a younger owner, while making relatively small contributions to all other workers (both older and younger). Fundamentally, the new comparability plans “carve out” older non-owners from the most lucrative components of the plan, and “carve

innovation to the new comparability plan is the “superintegrated” plan, which skews benefits to high-income owners by setting a very high compensation threshold beyond which the plan provides a substantially higher contribution rate.

55. LOUIS KRAVITZ & ASSOCIATES, INC., PLAN DESIGN OVERVIEW (1998), available at http://www.lkravitz.com/pdf_files/new_comparability.pdf (“We call this plan design ‘New Comparability.’”) (last visited Apr. 24, 2001) (on file with the Buffalo Law Review). Similar claims can be found on a host of other web sites of pension consulting firms. See, e.g., *New Comparability: Alive and Well*, BENEFIT INSIGHTS (W. E. Stanley & Company, Inc.), Dec. 2000, <http://www.westanley.com/binsight/12-2000.html> (“[I]n many cases cross-tested plans will continue to provide an optimum plan design to benefit the owners and key employees of a plan sponsor.”) (on file with the Buffalo Law Review); Arizona Qualified Plan Services, Inc., *New Comparability Profit Sharing and 401(k) Plans*, at <http://www.aqps.com/newcomp.htm> (n.d.) (last visited Apr. 24, 2001) (“The discrimination test is passed if the employees in the favored groups are older than the employees in the less favored groups with lower contribution percentages.”) (on file with the Buffalo Law Review); Texas Pension Consultants, *New Comparability Retirement Plans*, at <http://www.texaspension.com/pc/newcomparability/html> (n.d.) (last visited Apr. 24, 2001) (“[T]hese plans work best for employers whose owners and highly compensated employees are older (on average) than the company’s other employees.”) (on file with the Buffalo Law Review).

56. Joseph Nicola, *Reconfiguring Your Practice’s Pension Plan*, PHYSICIAN’S NEWS DIGEST, Feb. 1999, available at <http://www.physiciansnews.com/finance/299.html> (on file with the Buffalo Law Review).

in" younger owners into more attractive pension arrangements.⁵⁷

Table 1 offers an illustrative example of how the new approaches can tilt contributions toward favored owners. The firm has two co-owners and six workers.

Table 1

	Age	Compensation	Contributions Equal to 15% of Pay	Integrated with Social Security	First- Generation Cross- Tested Plan	New Comparability Plan
Owners						
	55	\$150,000	\$22,500	\$23,993	\$29,420	\$30,000
	50	\$150,000	\$22,500	\$23,993	\$19,566	\$30,000
Workers						
	60	\$40,000	\$6000	\$5276	\$11,797	\$1200*
	50	\$35,000	\$5250	\$4617	\$4565	\$1050*
	45	\$30,000	\$4500	\$3957	\$2602	\$900*
	25	\$25,000	\$3750	\$3298	\$750*	\$750*
	21	\$20,000	\$3000	\$2638	\$600*	\$600*
	21	\$15,000	\$2250	\$1979	\$450*	\$450*
TOTAL		\$465,000	\$69,750	\$69,750	\$69,750	\$64,950
Owners		\$300,000	\$45,000	\$47,985	\$48,986	\$60,000
Workers		\$165,000	\$24,750	\$21,765	\$20,764	\$4950
Owners' % of total		65%	65%	69%	70%	92%

* Reflects 3% mandatory contribution for top-heavy plans.

The owners are aged fifty and fifty-five, and the workers range in age from twenty-one to sixty. The third column in the table shows the compensation earned by each person in the firm: The owners earn \$150,000 each, and the workers earn between \$15,000 (for one of the twenty-one year old workers) and \$40,000 (for the sixty year old worker). Under the pension arrangements we examine, we have assumed that the plan is top-heavy and therefore all

57. Technically, a new comparability plan creates separate contribution rates for different types of workers, for example, owners and employees. The contribution rates are arranged to produce higher allocations for owners (and other favored employees) and lower allocations for rank-and-file workers. The trick of the new comparability design is to be able to create rate groups with different combinations of employees, with each rate group satisfying the nondiscrimination rules on a benefits basis.

employees will receive contributions of at least 3% of compensation. The table shows the pension contributions made on behalf of each person in the firm under different pension arrangements.

1. *Defined Contribution Plan with Contributions Equal to 15% of Pay.* Under the simplest defined contribution plan, each worker receives 15% of pay in his or her pension. As shown in the fourth column of the table, total pension payments amount to \$69,750, and the owners receive 65% of that amount. This pension plan is the simplest to understand: each worker receives a contribution equal to 15% of pay.

2. *Integrated with Social Security.* The next column shows one way in which the owners can tilt more of the contributions to themselves while keeping the total contribution amount the same. Even if the pension plan is tested on the basis of *contributions*, the owners can capture more of the contributions by taking advantage of various ways in which the nondiscrimination tests are relaxed. The fifth column shows the results when the firm takes advantage of the Social Security integration rules by contributing a higher percentage of pay above the maximum taxable Social Security earnings level in 2000 (\$76,200). Since the owners are the only ones in the firm with earnings above that level, they enjoy higher contribution rates than the rest of the firm, raising the percentage of contributions that accrue to the owners to 69%. By design, the total contributions to the pension plan remain \$69,750.

3. *First-Generation Cross-Tested.* The next column of the table shows the results for a cross-tested plan of the first generation, under which the plan's hypothetical retirement *benefits* rather than actual contributions are examined for nondiscrimination testing purposes. Since the two owners are older than the average worker, this approach allows the owners to tilt the benefits further in their direction. Under this traditional cross-tested plan, the owners are able to capture 70% of the total contributions while still enjoying the tax advantages enjoyed by qualified pension plans. Note, however, that the fifty year old owner receives a lower pension contribution than the fifty-five

year old owner and that the sixty year old worker receives a relatively large contribution. Total contributions remain \$69,750.

4. *New Comparability.* The final column of the table shows the results for the new comparability plan. The owners of the firm enjoy an astonishing 92% of the contributions under this plan, yet it still qualifies for the tax advantages provided by pension law. Note that relative to the traditional cross-tested plan, the firm has dramatically boosted the contribution for the fifty year old owner and dramatically reduced the contribution for the sixty year old worker. Also note that the firm's total contributions have declined, despite the increase in contributions made on behalf of the owners: The total contributions are now \$64,950, because the contributions made on behalf of workers are now only one-quarter (or less) of their level under the other plans.

II. PROFESSOR ZELINSKY'S ARGUMENT

Professor Zelinsky defends the first generation of cross-tested defined contribution plans by arguing that employers can achieve the same pattern of discrimination in favor of older employees by adopting a defined benefit plan.⁵⁸ (Professor Zelinsky assumes that all backloaded defined benefit plans are fully consistent not only with the nondiscrimination rules but also with the conceptual framework of the nondiscrimination principle.) He argues that "[t]here is no reason why a distribution of pension resources substantively acceptable when effected through the defined benefit motif should be deemed discriminatory when accomplished via the defined contribution form."⁵⁹ Fundamentally, he views a cross-tested defined contribution plan as equivalent to a defined benefit plan. Therefore, and since substance should control over form in this setting, cross-tested defined contribution plans should be permissible under the nondiscrimination rules as long as defined benefit plans are. Indeed, Professor Zelinsky views the ability to accomplish the discrimination in a defined contribution format positively, since it spares employers the

58. See Zelinsky, *Is Cross Testing a Mistake?*, *supra* note 9, at 594-97, 611.

59. *Id.* at 611.

regulatory costs of maintaining a defined benefit plan. Professor Zelinsky similarly defends the second generation of cross-tested plans (new comparability plans) by arguing that employers can achieve the same results through a combination of plans (and other sophisticated techniques).

In summary, Professor Zelinsky's argument is that since the Code countenances a given level of discrimination in some settings, it is rational for it to tolerate it in all situations. He concludes that the law would be improved either by (i) eliminating the nondiscrimination rules; or (ii) simplifying them through a top-heavy type of approach for all plans.

III: ANALYSIS OF PROFESSOR ZELINSKY'S ARGUMENTS

A. *Qualified Plans As a Tax Expenditure*

The first of Professor Zelinsky's alternative conclusions—that policy-makers should eliminate the nondiscrimination rules—reflects his belief that deferred compensation plans do not involve tax expenditures.⁶⁰ As he notes, "the premise that qualified plan law constitutes a tax expenditure, while widely accepted, is unconvincing. Without that premise it is difficult to justify much of the regulation of qualified plans, regulation rationalized on the grounds that it controls and channels the putative tax subsidy to qualified plans."⁶¹ Note that this argument is much broader than the cross-testing debate: It involves the entire set of regulations applying to qualified pension plans.⁶²

Given the structure of the current U.S. tax code, it appears difficult to argue that qualified pension plans do not result in tax expenditures. In particular, qualified contributions are deductible at the firm level and excluded from taxable income at the individual level. The accumulation of funds within a pension plan is not taxed; this tax-free "inside build-up" provides a significant rather than an additional tax benefit. (It is important to note that pension accumulations are taxed upon withdrawal, and the

60. *See id.* at 613.

61. *Id.* (citation omitted).

62. *See generally*, Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315 (1988).

tax expenditure should therefore be properly measured in net present value terms.) Since the tax preferences accorded to qualified pension plans cause foregone revenue that could have been used for other public purposes, regulation to ensure that the tax expenditure is meeting some policy objective is justifiable.⁶³

One pension economist, Richard Ippolito of George Mason University, has argued that the pension rules' departure from normative tax principles can be justified as a means of partly ameliorating the double taxation of savings under an income tax.⁶⁴ Ippolito's argument, however, is really an argument for a consumption tax base, a question that we regard as distinct from Professor Zelinsky's view that the tax treatment of pension plans is not a tax expenditure under an income tax base or that that expenditure does not require a social policy objective extrinsic to a normative definition of income.

The nondiscrimination rules were designed to meet one such policy objective: to ensure that lower- and middle-income workers share in the tax benefits from the qualified plan. As a well-known pension treatise notes:

A fundamental requirement of a tax-favored retirement plan is that the benefits or contributions under the plan must not favor highly compensated employees. Otherwise employers would be able to provide benefits only to highly compensated employees or could provide significant benefits to such employees and *de minimis* benefits to other employees. This is hardly the behavior Congress intended in establishing the tax incentives for retirement plans. Accordingly, the nondiscrimination rules prohibit plan benefits or contributions from favoring highly compensated employees.⁶⁵

63. See, e.g., Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 419-34 (1984); Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POL'Y 225 (1991); Edward A. Zelinsky, *Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein*, 9 AM. J. TAX POL'Y 257 (1991). We do agree with Professor Zelinsky's alternative conclusion, that it would be desirable to rethink the nondiscrimination rules and move toward a top-heavy type set of rules to replace the existing system. We return to that argument *infra* at notes 121-23 and accompanying text.

64. See generally RICHARD IPPOLITO, AN ECONOMIC APPRAISAL OF PENSION TAX POLICY (1990).

65. DAN M. MCGILL ET AL., FUNDAMENTALS OF PRIVATE PENSIONS 75 (7th ed. 1996). For a different perspective on the origins of the nondiscrimination rules,

Perhaps more important, Congress has expressly regarded the tax treatment of qualified plans as justified by social concerns extrinsic to the definition of an income tax base. The Senate Finance Committee Report on the Tax Reform Act of 1986, for example, includes the following:

For many years, the committee has supported measures that provide tax incentives designed to encourage employers to provide retirement benefits for rank-and-file employees. It has been the committee's intention that these tax incentives, which are more valuable for individuals with high levels of income because of their marginal tax rates, should be available to employers only if their plans provide benefits for rank-and-file employees.⁶⁶

In summary, most analysts and policy-makers agree that qualified pension plans generate tax expenditures. As such, nondiscrimination rules and other forms of regulation are warranted. The remainder of this article thus assumes that some version of nondiscrimination rules is justified.

Even if he agreed that some form of nondiscrimination rules were justifiable, however, Professor Zelinsky would argue that limitations on cross-testing would create an internal inconsistency in the current rules. This argument, as noted above, is predicated on the observation that the backloading of pension allocations toward older workers that can be accomplished under a cross-tested defined contribution plan can also be accomplished under a defined benefit plan. Since the defined benefit plan passes the nondiscrimination rules, the argument goes, so should the cross-tested defined contribution plan. We now turn to examining this argument.

B. *Inequivalency of Defined Benefit and Cross-Tested Defined Contribution Plans*

Professor Zelinsky's "substance should control over form" position incorrectly assumes that cross-tested defined contribution plans are equivalent to defined benefit plans with the same allocation of pension resources across the firm's workers in any particular year. The equivalency does not hold more broadly, however, undermining the assertion that the substance of the two plans is indeed the same. In

see *supra* notes 15-19 and accompanying text.

66. H.R. Rep. No. 99-313, at 578 (1986).

the absence of equivalent substance, we see no reason to expect the nondiscrimination rules to be equivalent: Policy-makers must balance the benefits and costs of different plans, and it is appropriate to have the nondiscrimination rules applicable to a specific type of plan reflect that balance.

A critical difference between a defined benefit pension plan and a defined contribution plan (whether or not it is cross-tested) involves the sharing of risk. In a defined benefit plan, the worker does not face investment risk during the pre-retirement accumulation stage (since the plan sponsor assumes such risk). Moreover, a worker may face only part of longevity risk (since defined benefit plans provide life annuities, but are generally not indexed post-retirement),⁶⁷ and does not face the dynamic risk of saving insufficiently over a career in anticipation of steep late-career compensation increases.⁶⁸ The relatively high regulatory costs of defined benefit plans are related to these types of risk shifting. In a defined contribution plan, by contrast, a worker generally must face such risks individually.⁶⁹

Professor Zelinsky himself notes that defined benefit and defined contribution plans are not equivalent in terms of risk-sharing: "Many commentators believe that the defined benefit format, since it shifts investment risk to the employer, is for many employees economically desirable in comparison with defined contribution arrangements under

67. It is worth noting that the vast majority of defined benefit plans, despite providing annuities, still expose retirees to longevity risk because most annuity payments are defined in nominal rather than inflation-adjusted terms. Over time, therefore, the real (inflation-adjusted) value of the annuity falls, partially exposing retirees to longevity risk.

68. See discussion *infra* Part III.B.1-2 (considering the nature of these risks).

69. To be sure, individuals can attenuate their exposure to these risks by adopting conservative investment strategies during the accumulation stage and purchasing an immediate life annuity upon retirement. But such risk-reduction strategies often have significant costs because of market imperfections. The private annuity market, for example, is characterized by selection effects: Those purchasing annuities tend to have longer life expectancies than the typical person. Insurance companies therefore price life annuities based on the pool of annuitants (with longer-than-average life expectancies) rather than the population as a whole. As a result, the expected net present value of annuity payments for the typical individual is 10-15% below the lump-sum purchase price. See Olivia S. Mitchell et al., *New Evidence on the Money's Worth of Individual Annuities*, 89 AM. ECON. REV. 1299 (1999).

which investment risk (and reward) belong to the employees."⁷⁰ In a footnote, Professor Zelinsky then indicates that he is one of those commentators.⁷¹ Since risk-sharing is a non-trivial concern, and since defined contribution and defined benefit plans generally differ in their risk-sharing characteristics, a cross-tested defined contribution plan is generally not equivalent to a defined benefit plan. Other differences also exist.⁷² Therefore, even if substance should control over form, the substance differs and the permissibility of defined benefit plans under the Code does not necessarily imply that cross-tested defined contribution plans should be permitted.

To be sure, the inequitable pension resource allocations achieved by a cross-tested defined contribution plan can be replicated within a defined benefit plan. Rather than suggesting the permissibility of cross-tested defined contribution plans, however, such equivalency highlights the importance of weighing the benefits of a defined benefit plan against its costs and perhaps for questioning the availability of defined benefit plans in circumstances under which the discriminatory impacts rather than the risk-sharing effects predominate. In larger firms, the risk-shifting characteristics of a defined benefit plan, combined with the difficulty of designing a plan to favor specific employees or even groups of employees while still satisfying

70. Zelinsky, *Is Cross Testing a Mistake?*, *supra* note 9, at 593.

71. *See id.* at 593 n.55.

72. Most cross-tested plans are profit-sharing plans to which firms decide whether and how much to contribute annually. In contrast, a firm cannot open and close the benefits spigot in a defined benefit plan on an annual basis; participants generally accrue benefits each year during a plan's life. In addition, the Internal Revenue Code limits deductible contributions to profit-sharing plans to 15% of the compensation of the participants, I.R.C. § 404(a)(3)(A)(i)(I) (1994 & Supp. III 1997), a limit not present in defined benefit plans. The Code also applies a special minimum participation requirement for defined benefit plans, *id.* § 401(a)(26), which at one time also applied to defined contribution plans. Congress subsequently limited the rule to defined benefit plans after determining that the abuse to which it was directed (setting up small defined benefit plans to benefit primarily owners) was not present in defined contribution plans. However, new comparability plans enable the same type of abuse that the section itself was designed to counter. Finally, and perhaps most important, most defined benefit plans are insured by the Pension Benefit Guaranty Corporation (PBGC), so employees are shielded not only from investment risk but also the risk of employer underfunding. Cross-tested defined contribution plans are not defined contribution plans and therefore are not insured.

the nondiscrimination rules, suggest that its public policy benefits will usually outweigh its costs. We would argue that the Code should therefore continue to allow such plans even while disallowing cross-tested defined contribution plans.

The situation is somewhat more complicated in smaller firms, where the majority of cross-tested defined contribution plans is found.⁷³ In smaller firms, the benefits of actual defined benefit plans may be more apparent than real.⁷⁴ In particular, small defined benefit plans are often designed to provide benefits primarily for proprietary employees and risk-shifting effectively does not occur. The regulatory costs associated with defined benefit plans are thus largely wasted, and the inequitable resource allocation (similar to that in a cross-tested defined contribution plan) is unjustified.

As noted above, three types of risk-shifting may occur in a defined benefit plan setting: investment risk, mortality risk, and compensation escalation risk. We analyze each of these risks in the context of a small firm, with an owner employee and several nonproprietary employees. In our analysis, we assume that (i) the firm adopted the plan at a time when the owner was older than the nonproprietary employees and that (ii) the firm will terminate the plan when the owner retires, approximately ten years after the plan's adoption. In such a plan, the bulk of the firm's contributions will fund the owner's benefit accruals (because of the disparity of age between the owner and the other employees), just as in a cross-tested defined contribution plan.

1. *Risk-Shifting with Respect to Owner.*

a. *Investment Risk.* Since the firm's owner is funding the plan with her own resources, the investment risk is only

73. See Press Release, American Society of Pension Actuaries, ASPA Survey Confirms "New Comparability" Expands Small Business Retirement Plan Coverage (May 17, 2000), available at <http://www.aspa.org/archivepages/gac/2000/newcomppressrel.htm> (on file with the Buffalo Law Review) [hereinafter ASPA Survey]. The survey of 10,000 new comparability plans found that 90% of such plans were adopted by businesses with fifty or fewer employees; 36% were maintained by plans with fewer than ten employees. *Id.*

74. See Stein, *supra* note 12, at 1410. See generally Daniel Halperin & Marla Schnall, *Regulating Tax Qualified Pension Plans in a Hybrid World*, 58 N.Y.U. INST. FED. TAX'N, at 5-1 (2000).

nominally transferred to the plan. The owner will benefit from better-than-anticipated investment return in the form of lower future contributions to the plan (or larger benefits or a larger reversion at the plan's termination) and will suffer from lower-than-expected investment return.

b. *Longevity Risk.* The Internal Revenue Code requires that defined benefit plans provide an annuity form of benefit, at least as the normal form of benefit. A participant who takes benefits in this form ensures that her pension savings will not be exhausted prior to death. Thus, the participant is protected, at least partly, from the risk of longer-than-anticipated mortality, which we refer to as longevity risk. In effect, this risk is shifted to some combination of the employer and the pool of other plan participants who take annuitized benefits. In the case of the small firm we have described, however, the owner cannot effectively shift the actuarial risk of longevity to the firm because the firm and owner are virtually identical. The owner is also unable to shift the risk to the pool of other employees because the present value of the benefits of the other employees are too small, and their starting date too distant, to justify annuitization. We note that the owner can shift risk by purchasing a commercial annuity contract, but this will subject the owner to potentially higher costs for the longevity protection.⁷⁵

c. *Compensation Escalation Risk.* A defined benefit plan, through a final pay formula, can shift the risk of substantial late-career compensation increases to the firm. The "risk" is that an employee will experience rapid compensation increases toward the end of her career and not be able to finance enough consumption during retirement to maintain a standard of living close to that immediately prior to retirement. In other words, the worker will not have sufficient pension resources accumulated to finance an acceptable replacement rate during retirement. (If individuals were perfectly rational and forward-looking, unexpected increases in compensation toward the end of a career would be mostly saved rather than consumed,

75. Moreover, the risk-shifting here would not have occurred because of the defined benefit form of plan, but because of the purchase of the annuity contract.

obviating this problem. But significant evidence suggests that most individuals do not behave in a perfectly rational and forward-looking manner.⁷⁶) The shifting of this risk is important if a goal of retirement policy thus is to permit an employee to continue in retirement a percentage of the compensation income he had achieved in the period immediately before retirement. One can question whether a replacement rate target should be an important goal of national retirement policy, but even assuming it is, the owner of a firm realizes no shifting of risk by nominally transferring it to the firm.

2. *Risk-shifting with Respect to Nonproprietary Employees.*

a. *Investment Risk.* A defined benefit plan does shift the risk of investment return for nonproprietary employees to the firm. But the societal gain of such risk shifting is marginal for two reasons. First, the present value of benefits for such employees (and thus the degree of risk shifting) is likely to be trivial if the employees are young. Second, when such employees separate from the firm, they are likely to take their benefits in a lump sum.⁷⁷ The amount of the lump sum is dependent on interest rates at the time of separation, subjecting them to unpredictable investment loss due to interest rate fluctuation.

b. *Longevity Risk.* Because the nonproprietary employee is likely to take a defined benefit in a lump sum prior to retirement, the shifting of longevity risk through the plan is improbable.

c. *Compensation Escalation Risk.* The nonproprietary employee will cease participating in the plan long before the end of her career and thus any shifting of sudden compensation increases to the firm will generally be trivial.

76. See generally RICHARD THALER, *QUASI-RATIONAL ECONOMICS* (1991).

77. The firm can, in fact, force the employee to take a lump sum benefit if the present value of the benefit is less than \$5000, which will often be the situation for a younger employee.

Small defined benefit plans of the type we described, then, offer little of the risk shifting characteristics that the complicated regulatory structure for defined benefit arrangements is designed to accommodate. The high regulatory costs imposed on small defined benefit plans may effectively act as a "gate charge" that discourages such plans. Some analysts, including Professor Zelinsky, view these regulatory costs as unwarranted and problematic precisely because they discourage defined benefit plans in small businesses.⁷⁸ Our view differs: We view the regulatory costs as an impediment to a socially costly form of qualified plan. Given the failure of many small defined benefit plans to shift risk significantly, and the related ability of such small plans to target benefits to a few specific employees, this disincentive is beneficial from a policy perspective.

We do not, of course, make the claim that all defined benefit plans in small firms fail to shift meaningful levels of risk from their participants. Rather, we argue that small defined benefit plans should be limited to situations in which meaningful risk-shifting of the sort we described does occur. As we will describe later, this should require a factual inquiry into whether a plan is intended to be permanent from the perspective of covered nonproprietary employees.⁷⁹

Put simply, defined benefit plans that do not involve risk-shifting for participants should not be permitted tax-qualified status under the Code. The current regulatory structure, by erecting significant barriers to the adoption of defined benefit plans in small firms, may represent an inefficient regulatory approach for accomplishing that goal. The solution, however, is not to remove any regulatory obstacles to the adoption of defined benefit plans in small firms, but rather to adopt a more direct and transparent approach to limiting them.

We thus reject Professor Zelinsky's argument that the substance of cross-tested defined contribution plans is equivalent to that of defined benefit plans. Furthermore, when such equivalency does roughly obtain, such as in some small business settings, the implication is that both forms of plan should be disqualified, not that both forms should be allowed.

78. See, e.g., Zelinsky, *Is Cross-Testing a Mistake?*, *supra* note 9, at 610-11.

79. See *infra* text accompanying notes 110-12.

C. I.R.C. § 415

A second flaw in Professor Zelinsky's argument relates to I.R.C. § 415. Section 415 specifies limitations on the maximum amounts that can be contributed to a defined contribution plan or received from a defined benefit plan on behalf of an individual worker. For example, § 415(b) specifies that for workers retiring at the full benefit age under Social Security (currently age sixty-five), the maximum amount that can be received per year in retirement from a defined benefit plan is \$140,000, or 100% of compensation, whichever is lower.⁸⁰ Section 415(c) specifies that for workers participating in a defined contribution plan, the maximum combined employer-employee contribution per year is \$35,000, or 25% of compensation, whichever is lower.⁸¹ The limits thus apply separately to defined contribution and defined benefit plans. Until January 2000, however, § 415(e) limited the aggregate amount of benefits *and* contributions that a firm could provide if it sponsored both a defined contribution plan and a defined benefit plan. Effective January 1, 2000, § 415(e) was repealed.⁸² Because of the constraints of § 415, some levels of age-based discrimination can be achieved only through use of cross-testing.

Depending on the assumed interest rate, § 415 limits the present value of a defined benefit accrual to an amount less than the annual defined contribution limit until an employee reaches approximately age forty-five.⁸³ Consider a firm with a thirty-five year old owner and a twenty year old

80. The defined benefit limit is set at the lesser of 100% of compensation or \$90,000, with the dollar limit indexed to the cost of living in \$5000 increments. See I.R.C. § 415(b), (d) (1994 & Supp. III 1997). The dollar limit is currently \$140,000, but is adjusted downward if the benefit begins earlier than social security retirement age. *Id.* § 415(b)(2)(C) (1994).

81. The defined contribution limit is set at the lesser of 25% of compensation or \$30,000, with the dollar limit indexed to the cost of living in \$5000 increments. See *id.* §415(c), (d) (1994 & Supp. II 1996). The indexing, however, was delayed until such point as the defined contribution limit would be one-third of the defined benefit limit. This point occurred when the defined benefit limit reached \$140,000 at the beginning of 2001. Thus, the defined contribution limit was increased to \$35,000.

82. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, Title I, § 1452(a), 110 Stat. 1816 (1996).

83. See generally Stein, *Simplification and IRC § 415*, *supra* note 38, at 73-80.

employee. If the firm adopts a cross-tested defined contribution plan, it can test on an age-weighted basis and still provide the owner with a \$35,000 contribution. If the firm cannot cross-test and wishes to maximize the age-weighted benefit disparity between the owner and the younger employee, the firm would have to adopt a defined benefit plan, which would provide the owner with a benefit with a smaller present value. Depending on the actuarial assumptions used, the present value of the benefit accrual would probably be less than \$20,000.⁸⁴ In addition, the employer would have the extra administrative and actuarial expenses associated with a defined benefit plan.

Moreover, even if a defined benefit plan were substantively equivalent to a cross-tested defined contribution plan, there is little policy justification for allowing the firm to create *two* backloaded plans, as is effectively the case given the repeal of § 415(e) and the permissibility of cross-tested defined contribution plans. In other words, Professor Zelinsky is wrong when he argues that cross-tested defined contribution plans should be permitted because the same disparities could be achieved with a defined benefit plan. A firm can make much larger age-weighted contributions if it can fund both a defined benefit plan and a cross-tested defined contribution plan rather than just a defined benefit plan. It is difficult to see why two defined benefit plans should be prohibited under § 415(b), but one defined benefit plan (under § 415(b)) plus an effectively identical defined contribution plan (under § 415(c), combined with cross-testing) should be permissible. Given the current structure of § 415, Professor Zelinsky's argument regarding the equivalency of a cross-tested defined contribution plan and a defined benefit plan does not hold for firms that sponsor both types of plans.

D. *Backloaded Pension Plans*

Some supporters of cross-testing defend backloaded benefit formulas as a means of addressing two related problems that are sometimes encountered by middle-aged owners of small firms: the firm was not sufficiently

84. Assuming a level-dollar funding method, a 6% interest rate and a \$140,000 annual annuity beginning at age sixty-five, with a projected present value of \$1,400,000 at age sixty-five, the actual contribution would be \$17,708.

profitable when the owner was young to permit the establishment of a qualified deferred compensation program, and the owner consequently entered middle age undersaved for retirement.⁸⁵ Cross-testing is necessary to facilitate the owner's rapid accumulation of retirement wealth during the period beginning with firm prosperity and ending with retirement.

One can first respond that this justification for cross-testing applies to a narrower band of small firms than are actually eligible to use cross-testing. For example, a fifty year old physician with a twenty-five year old nurse is eligible to use cross-testing even if she has already accumulated several million dollars in qualified plans.

Moreover, if we accept that the tax expenditure for qualified plans finds its justification in helping middle and lower-income individuals save for retirement, there is a serious policy problem in a tax regime that helps the undersaved older proprietary employee save rapidly for retirement but requires no similar solicitude for the older undersaved rank-and-file worker, who will almost certainly be excluded from rapid retirement accumulations in a new comparability plan. Moreover, a young employee of a firm with even a first-generation age-weighted plan is unlikely, later in life, to be employed by a firm with age-weighted benefits.

If private plans are to provide a significant supplement to Social Security for lower and middle income individuals, policy should encourage a pattern of meaningful early deferrals so that such individuals will benefit from the compounding of interest. Cross-tested plans, and many small defined benefit plans, by providing small contributions for younger employees, are at odds with this insight.

IV. PROPOSED LEGISLATION⁸⁶

The policy costs of permitting cross-testing would be exacerbated by pension changes being debated on Capitol Hill.⁸⁷ Legislation that passed the House of Representatives

85. See, e.g., GRAFF, *supra* note 47. Professor Zelinsky's article does not raise these issues.

86. See *supra* note 13.

87. For a discussion of the problems associated with these proposed

by a large majority last year (and similar legislation that cleared the Senate Finance Committee but was not finally acted upon by the Senate) would have raised various limits affecting additions to defined contribution plans.⁸⁸

Under current law, the combined employer-employee contributions to defined contribution plans may not exceed the lesser of \$30,000, or 25% of pay.⁸⁹ In addition, tax-favored pension benefits are currently based on compensation up to a maximum compensation level of \$170,000.⁹⁰ The maximum considered compensation limit, and the limits on defined contribution amounts, are often the only limiting factors on contributions for older owners and partners under new comparability plans. The legislation would have raised the maximum compensation level to \$200,000, increased the combined employer-employee contribution limit to \$40,000 and eliminated the requirement that such contributions not exceed 25% of pay.⁹¹ The legislation would also have relaxed the top-heavy protections.⁹²

To see how the proposed changes could further skew contributions toward high-income owners, and even endanger pensions for lower-income workers, consider again the hypothetical firm explored above.⁹³ We consider two of the proposed changes in the bills mentioned above: Increasing the combined employer-employee contribution limit from \$30,000 to \$40,000, and relaxing the top-heavy rules by effectively excluding family members who are not officers or owners of the firm from the definition of a "key

changes, see PETER R. ORSZAG ET AL., EXACERBATING INEQUITIES IN PENSION BENEFITS: AN ANALYSIS OF THE PENSION PROVISIONS IN THE TAX BILL (1999), available at <http://www.cbpp.org/10-8-99tax.htm> (on file with the Buffalo Law Review), and PETER R. ORSZAG ET AL., CRITICISM OF CBPP PENSION ANALYSIS RESTS ON SELECTIVE USE OF DATA AND LEAVES MISLEADING IMPRESSIONS (1999), available at <http://www.cbpp.org/10-28-99tax.htm> (on file with the Buffalo Law Review).

88. See H.R. 1102, 106th Cong. § 201 (1999).

89. The \$30,000 dollar amount has since been increased through automatic indexation to \$35,000. See I.R.S. News Release IR-2000-82 (Nov. 20, 2000).

90. See *id.*

91. See H.R. 1102, 106th Cong. § 201 (1999).

92. See *id.* § 203.

93. See *supra* Table 1 and accompanying text.

employee" for the purposes of determining whether a plan is top-heavy.⁹⁴

Table 2

	Age	Compensation	New Comparability Plan Current \$30,000 Maximum	New Comparability Plan Proposed \$40,000 Maximum	New Comparability Plan Top-Heavy Protections Relaxed
Owners					
	55	\$150,000	\$30,000	\$34,590	\$30,000
	50	\$150,000	\$30,000	\$34,590	\$30,000
Workers					
	60	\$40,000	\$1200*	\$1200	\$1041
	50	\$35,000	\$1050*	\$1050	\$911
	45	\$30,000	\$900*	\$900	\$781
	25	\$25,000	\$750*	\$750	\$650
	21	\$20,000	\$600*	\$600	\$520
	21	\$15,000	\$450*	\$450	\$390
TOTAL		\$465,000	\$64,950	\$74,131	\$64,293
Owners		\$300,000	\$60,000	\$69,181	\$60,000
Workers		\$165,000	\$4950	\$4950	\$4293
Owners' % of total		65%	92%	93%	93%

* Reflects 3% mandatory contribution for top-heavy plans.

The third column in Table 2 shows the new comparability plan under current law. The next column shows the impact on the new comparability plan of raising the maximum combined employer-employee contribution from \$30,000 to \$40,000. The first effect of the higher limit is to allow high-income owners to raise their pension contributions. In our example, the contribution for each owner increases from \$30,000 to \$34,590. Advocates of high contribution limits argue that in many cases, the nondiscrimination rules would require any such increase in contributions for high-income owners to be matched by higher contributions for lower-income workers.

The example highlights why the nondiscrimination rules often do *not* require such higher contributions for lower-income workers, especially in the context of new

94. For purposes of our comparison, we have used the § 415 limit of \$30,000 applicable for the year 2000.

comparability plans. In this example, the contributions made on behalf of lower-income workers do not increase at all. Yet the firm still meets the nondiscrimination test despite the higher contributions for the owners. In other words, the entire increase in total contributions accrues to the high-income owners, who already were receiving 92% of the pension contributions. The change in the maximum contribution limit allows the owners to accumulate almost \$10,000 more in tax-favored pension saving, and raises their share of total contributions to 93%. Moreover, if the owners wished, they could raise their contributions to the \$40,000 limit if they were willing to contribute an additional \$774 for the benefit of the workers (raising the workers' total benefits from \$4950 to \$5274).

The final column shows the impact of relaxing the top-heavy protections as proposed in several legislative packages. Assume the two owners are spouses. The proposed changes would allow the firm to avoid the top-heavy protections simply by having one spouse shift ownership to the other spouse (while both still receive \$150,000 in compensation). The hypothetical plan would then no longer be top-heavy, as it is in all the other examples in the tables. The firm could *reduce* the contributions made for all other employees by 13% (from \$4950 to \$4300), while maintaining the \$30,000 contributions for both spouses. In other words, the proposed change would not only further skew the contributions toward the high-income couple, but also reduce pension contributions for the other workers.

The legislation would also have increased the defined benefit annuity limit from \$135,000 to \$160,000,⁹⁵ and permitted plans to pay unreduced benefits at age sixty-two (which would currently require an actuarial reduction).⁹⁶ Small firms sponsoring both a defined benefit plan and a cross-tested defined contribution plan would have been able to contribute in excess of \$150,000 to retirement plans for a fifty-five year old with taxable compensation of \$160,000 per year.⁹⁷ In other words, the firm would be able to pay deferred compensation equal to over 90% of the highly paid employee's taxable compensation. At the same time, the

95. See H.R. 1102, 106th Cong. § 201(a)(1) (1999).

96. See *id.*

97. This assumes a 7% interest rate and a level funding method.

firm could limit its contribution to a twenty-five year old employee with \$25,000 of compensation to about \$2000, or less than 10% of taxable compensation. The tax cost of getting the employer to contribute the \$2000 into a retirement savings account for the twenty-five year old under these circumstances is considerably more than the \$2000 contribution itself.⁹⁸

V. TREASURY REGULATIONS⁹⁹

The second generation of cross-tested plans, in which firms structure their qualified plans to provide age-weighted benefits to older highly compensated employees while denying age-weighted benefits for older rank-and-file employees impose high social costs (if we accept the notion that qualified plans generate tax expenditures and need an external social justification). Furthermore, those costs would rise if the legislation under debate in Congress becomes law. The Internal Revenue Service reacted to these costs by issuing a Notice in February 2000, in which it expressed concern about new comparability and other plans in which higher benefit rates were explicitly reserved to a few favored highly compensated employees.¹⁰⁰

The Notice suggested that Treasury would not revisit the permissibility of first-generation cross-tested plans, in which all employees of similar age and service are treated similarly, even if firm demographics imply that only a few highly paid employees in fact benefited from the higher accrual rates.¹⁰¹ But the Notice evinced a preliminary view that some of the second-generation plans impermissibly discriminate by barring high benefit rates to employees based on compensation rather than age. The Notice suggested that Treasury considered some (but not all) cross-

98. The nominal tax cost is \$60,000, assuming a 40% marginal tax rate. The effective tax cost, on a present value basis, depends on interest rate assumptions, marginal tax rates, and length of deferral. Assuming 6% interest, a 40% marginal tax rate, and a fifteen year deferral period, the tax cost would exceed \$40,000.

99. See *supra* note 14.

100. I.R.S. Notice 2000-14, 2000-1 C.B. 737 (2000). The Notice indicated that it reflected the concerns of both Treasury and the I.R.S.

101. *Id.* (stating that "the Service and Treasury anticipate that cross-testing would continue to be a permissible alternative for generic age-weighted or service-based defined contribution plans").

tested plans discriminatory if, under the plan, older rank-and-file employees did not benefit from the higher benefit formulas, or if the plan adopted a formula in which other rank-and-file employees could not "grow" into the higher benefit structure as they aged.¹⁰²

In October 2000, Treasury followed up on the Notice by issuing proposed regulations.¹⁰³ The regulations manifest the concerns of the Notice. From our perspective, there are three significant aspects to the regulations.

First, the regulations do not limit the use of what we have referred to as first-generation age-weighted plans (and which the Notice referred to as "generic age-weighted" plans).¹⁰⁴ Second, the regulations permit any age-weighted defined contribution plan to be tested on a benefits basis so long as the plan provides a minimum "gateway" allocation to non-highly compensated employees; the allocation must equal the lesser of 5% or one-third the highest allocation rate among the highly compensated employees.¹⁰⁵ Finally, the regulations permit new comparability plans so long as each allocation rate is currently available to a group of employees that would satisfy the § 410(b) coverage rules; however, the regulations permit use of the non-discriminatory classification part of the average benefits test without regard to whether the average benefits of the non-highly compensated employees are at least 70% of the benefits of the highly compensated employees.¹⁰⁶

102. *See id.* For example, some cross-tested plans, known as super-integrated plans, base the higher allocation rates on a participant's compensation. In such plans, a lower paid employee could never obtain the advantage of a higher benefit formula (as a percentage of pay).

103. *See* Prop. Treas. Reg. §§ 1.401(a)(4)-8(b), 1.401(a)(4)-9(b)(2)(v), 65 Fed. Reg. 59,774 (Oct. 6, 2000).

104. *See* Prop. Treas. Reg. § 1.401(a)(4)-8(b)(1)(B)(iii), 65 Fed. Reg. at 59,778; Preamble to Proposed Regulations on Nondiscrimination Requirements for Certain Defined Contribution Retirement Plans, 65 Fed. Reg. at 59,775.

105. *See* Prop. Treas. Reg. § 1.041(a)(4)-8(b)(1)(iv), 65 Fed. Reg. at 59,778.

106. *See id.* § 1.401(a)(4)-8(b)(1)(iii), 65 Fed. Reg. at 59,778. The regulations also limit the use of cross-testing for its historic purpose: when a defined benefit and defined contribution plan are combined for purposes of § 410(b) testing. Recall that cross-testing is necessary here if the plans are aggregated, for the aggregation requires the comparison of benefits and contribution allocations. *See supra* notes 48-49 and accompanying text. The proposed regulations would continue to permit this traditional use of cross-testing but only if the benefits in the defined benefit plan are converted into comparable allocations, or if the aggregated plans are either "primarily defined benefit in character" or are both "broadly available" (concepts defined by the regulations). *See* Prop. Treas. Reg. §

We view the regulations as a significant first step in limiting the use of cross-testing for defined contribution plans. In particular, the introduction of a meaningful minimum allocation for non-highly compensated employees is an innovative regulatory manifestation of the nondiscrimination norm. But the regulations, by permitting generic age-weighted plans, do not address the broader concerns about cross-testing that we raise in this paper: that benefit testing should be reserved to defined benefit plans that produce meaningful shifting of the risks of investment performance, longevity, and sudden compensation increases to the firm and other employees. In fairness to Treasury, this type of change, at least insofar as it also applies to many small-firm defined benefit plans, may require legislative attention.

At least on a symbolic level, however, the regulations do limit some of the more egregious instances of new comparability plans: plans where high allocation rates are explicitly reserved for higher-paid employees, with no possibility of lower-paid employees ever enjoying those rates. If plans did not satisfy the minimum gateway requirements, the regulations would deny the use of cross-testing unless those plans covered a group of employees that would satisfy the diluted ratio percentage requirements of the regulation's average benefits test.¹⁰⁷ The regulations thus ensure a nondiscriminatory group of employees who are either currently benefiting from age-based allocation rates or who could, in the language of the Preamble of the regulations, "grow into" the higher allocation rates as the participants age or accumulate seniority.¹⁰⁸

The problem with this regulatory approach is that it assumes both that the plan will survive the retirements of the older highly compensated employees and that at least

1.401(a)(4)-9(b)(2)(v)(B), (C), 65 Fed. Reg. at 59,779. The regulations thus limit cross-testing on a benefits basis to situations in which the proposed regulations' other requirements for cross-testing are satisfied, or when the combination of plans is not designed to bypass those requirements.

107. See Prop. Treas. Reg. § 1.401(a)(4)-8(b)(1)(iii), 65 Fed. Reg. at 59,778. We do not, however, see the logic in allowing firms to use the lower ratio percentages of the average benefits test regulations without satisfying the average benefits test; we would limit most employers to the 70% general ratio percentage test.

108. See 65 Fed. Reg. at 59,775.

some of the rank-and-file workers will continue to be employed (and to participate in the plan) as they grow older. In some small firms, however, the probability of these events is quite low. Assume, for example, a small law office, with two attorneys in their fifties and three support employees in their twenties and thirties. It is likely that when the attorneys retire, the firm will wind down its business; even if the firm continues in the hands of other attorneys, it is far from clear that the new owners will continue the age-based plan or that the original support employees will still be employed. Moreover, even if the rank-and-file workers are still employed, the plan could presumably be amended to exclude them from participation and pass the nondiscrimination test by adding new younger support employees to the plan. As Professor Zelinsky points out, in the types of situations we just described, younger rank-and-file employees will never as a practical matter grow into the higher allocations.¹⁰⁹

The regulations could potentially be revised to address these types of situations by drawing upon another requirement of qualified plans: that the firm intend the plan to be "a permanent as distinguished from a temporary program."¹¹⁰ A cross-tested plan, in our view, does not satisfy the permanence requirement if the plan has a high probability of termination before the rank-and-file employees have an opportunity to enjoy higher age- and seniority-based allocation rates.

We address three objections to this position. The first is that the permanence requirement should not distinguish among different varieties of plans: if an age-weighted profit-sharing plan is not permanent because it will likely terminate if the firm's key employees are expected to retire within ten or so years of the plan's adoption, then a contributions-tested profit-sharing plan should presumably also not be permanent in such situations. We respond by noting that the permanence requirement has, for more than half a century, been linked to nondiscrimination concerns. The regulations establishing the permanence requirement provide that while a firm can reserve the right to change or terminate the plan, a plan will be suspect under the permanence rule "if, for example, a pension plan is

109. See Zelinsky, *Is Cross-Testing A Mistake?*, *supra* note 9, at 595-98.

110. Treas. Reg. § 1.401-1(b)(2) (as amended in 1976).

abandoned soon after pensions have been fully funded for persons in favor of whom discrimination is prohibited under section 401(a).¹¹¹ This linkage of permanence and the nondiscrimination norm should apply to cross-tested defined contribution plans in which higher allocation rates are, as a practical matter, reserved for a few highly paid employees.

The second objection is a practical one: How can the IRS administratively determine which plans are not intended to be permanent? Some firms with older owners will undoubtedly continue beyond the retirement of those participants and new owners may continue the plan. Even if such decisions are indeed too difficult to be made in practice—which we are not persuaded is the case—regulators could simply take the position that a cross-tested plan is assumed to be permanent from inception. If the plan is then terminated before rank-and-file employees grow into their benefits, the firm could be forced to make curative allocations for rank-and-file employees or suffer retroactive disqualification.

The third objection is that this requirement will impose an undue regulatory burden on the firms using a cross-tested approach to meeting the nondiscrimination rules. Our response is that we would prefer to prohibit cross-testing altogether. In the absence of such an outright prohibition, it does not seem unfair to impose a small regulatory burden on the affected firms in order to ensure that the substantial benefits afforded by cross-testing are not unduly abused.

This third objection is related to a criticism of the regulations from some critics: that the regulations will result in many small businesses abandoning their plans rather than complying with the new restrictions, which will in turn harm rather than help rank-and-file employees with whose welfare the proposed regulations are primarily concerned.¹¹² We offer two responses to this argument.

111. *Id.*

112. *See, e.g., Writers Speak Out on the Proposed Regulations on New Comparability Plans*, 90 TAX NOTES 595 (2001); *Debate on Restrictions on New Comparability Plans Continues*, 87 TAX NOTES 1470 (2000); Letter from American Society of Pension Actuaries, to I.R.S. (Jan. 5, 2001), http://www.aspa.org/archivepages/gac/2001/New_Comp_Comment_Letter.htm (last visited July 7, 2001) (on file with the Buffalo Law Review).

First, to determine the validity of this critique, it is necessary to weigh the adverse effects on rank-and-file employees of likely plan terminations against the losses such employees currently suffer because firms willing to sponsor traditional defined contribution plans have shifted to an age- or seniority-weighted, or new comparability, format. Until such a study has been undertaken, we regard the underlying argument simply as an assertion without any clear empirical backing.¹¹³

Second, this type of criticism of the proposed regulations raises a more fundamental question: whether the considerable tax cost of new comparability plans can be justified by the almost trivial level of benefits provided to many rank-and-file employees. There are certainly less costly ways of assisting rank-and-file workers to save for retirement than dangling extravagant tax benefits to the owners of small firms to set up plans in which most rank-and-file workers receive contributions equal to 3% of their

113. The American Society of Pension Actuaries (ASPA) has conducted a study, but it does not answer the questions we posed. *See* ASPA Survey, *supra* note 73. The study does say that 50% of small firms that currently sponsor new comparability plans would decline qualified plan sponsorship if they had to test their plans on a contributions basis, *id.*, but this means that another 50% of small employers (and presumably a larger percentage of other employers) would continue sponsoring plans—plans that might provide better coverage for rank-and-file employees. The ASPA study also indicates that 49% of new comparability plans provide contributions equal to at least 5% of pay, but the number apparently is based on the pay of all employees rather than just rank-and-file employees. *See id.*

The ASPA survey, the instrument for which is archived on the ASPA Web site, *see* American Society of Pension Actuaries, New Comparability Plan Survey (2000), at <http://www.aspa.org/archivepages/gac/2000/gacsurvey.htm> (last visited April 27, 2001) (on file with the Buffalo Law Review), has some methodological shortcomings. The survey was conducted via the internet, with questions to be completed by actuaries. *See id.* The actuaries were asked how many plans they represented and then were asked to make subjective judgments as to how many plans would be terminated rather than redesigned if new comparability were no longer permitted. *Id.* We note that the response to this question was the judgment of the actuary about what a plan sponsor would do. Aside from the problems inherent in casually surveying a group of consultants about what their clients might hypothetically do, the question did not ask what would happen if the proposed regulations were adopted; rather, the question asked what would happen if new comparability plans were no longer available. *See id.* However, the regulations would not end new comparability plans, but instead would place some restrictions on their use. The ASPA summary of the responses to the survey, *see* ASPA Survey, *supra* note 73, also ignores answers to some survey questions, which suggests the possibility that those responses might not have fully supported ASPA's policy positions.

compensation. Indeed, it might be far less expensive to give workers a matching credit for their contributions to IRAs.

VI. SUGGESTIONS FOR REFORM OF NONDISCRIMINATION STANDARDS

Professor Zelinsky suggests that cross-testing exposes an insoluble incoherence in the nondiscrimination norm, at least for small firms: whether a plan is discriminatory often turns on the form by which qualified plan accumulations are measured, as contributions or benefits. Rules barring or limiting cross-testing, furthermore, cannot introduce coherence to the norm, since firms ultimately have access to both defined contribution and defined benefit plans. Firms will, Professor Zelinsky observes, continue to be able to test on a benefits basis by adopting a defined benefit plan.

This argument overstates the level of incoherence in the current rules, since a decision to adopt a defined benefit plan is not equivalent to the adoption of a defined contribution plan. Employees generally derive no risk-shifting from the adoption of a defined contribution plan, may find that the employer can choose to provide no benefits in particular years, and do not have a benefit guaranty from a government agency (the PBGC).¹¹⁴ Moreover, the putative incoherence can be resolved either by limiting the availability of defined benefit plans to situations in which meaningful risk-shifting is likely to occur, or by imposing a more rigorous "permanence" requirement for both defined benefit and cross-tested defined contribution plans.

We do not, however, overestimate the political will to effect such changes and thus find ourselves in practical agreement with Professor Zelinsky's assessment that the nondiscrimination rules—at least with respect to small firms—lack substance. Moreover, cross-testing is not the only reason that the nondiscrimination rules lack substance. Earlier in the article, we alluded to some of the other strategies that a firm might harness in order to create a substantial degree of discrimination in favor of highly-compensated employees, including limiting coverage, requiring vesting service, integrating benefits with Social

114. See *supra* note 72.

Security, and crediting past service credits.¹¹⁵ Thus, we doubt the efficacy of today's nondiscrimination rules in many small business settings to produce meaningful retirement savings for rank-and-file employees who participate in such plans.

It is here, however, that we part company with Professor Zelinsky. He does not believe that the tax treatment of qualified plans, which produces substantial tax savings for people who are able to defer compensation into such plans, should be characterized as tax expenditures requiring some social or economic justification extrinsic to the purposes of an income tax.¹¹⁶ We are among those people who subscribe to the opposite view, which Professor Zelinsky in an understatement labels conventional wisdom:¹¹⁷ that the tax regime for qualified plans varies from the normative features of an income tax and thus can be justified only as a tax expenditure. Thus, unlike Professor Zelinsky, we would not abandon the goal of using regulation to promote the share of the aggregate tax expenditure enjoyed by, and the retirement savings undertaken by, rank-and-file workers. Indeed, in our view, societal willingness to continue to maintain the special tax treatment for qualified plan savings should hinge on our ability to improve the operation of the nondiscrimination rules.

Professor Zelinsky argues that his conclusions about the ineffectiveness of the nondiscrimination rules contain a lesson for those "favoring a more paternalistic pension policy" than he favors.¹¹⁸

For those troubled by the outright abolition of the nondiscrimination norm, but skeptical of introducing more complexity to the qualified plan regime, a viable alternative to the status quo is to replace the nondiscrimination norm with straightforward minima, for example, any defined contribution plan must provide each participant with a contribution of at least 3% annually¹¹⁹

115. See *supra* Part II.B.

116. Zelinsky, *Is Cross Testing a Mistake?*, *supra* note 9, at 595.

117. *Id.*

118. *Id.* at 626.

119. *Id.*

Here, we agree with Professor Zelinsky, although with some reluctance, and offer a variation on his proposal that we think holds somewhat more promise for increasing the retirement security of rank-and-file workers.

Under current law, the basic conceptual model for the nondiscrimination norm is one of proportionality: highly compensated and rank-and-file employees receive the same level of benefits as a percentage of pay. Firms often go to great lengths to design their plans to escape this proportionality model, i.e., to provide a higher benefit level to highly compensated employees, because they believe that higher paid employees place more value on tax-deferred savings than rank-and-file employees, and that the optimal level of deferred compensation is much lower for the latter than the former.

The current regime does not reflect a meaningful proportionality requirement for most small firms, however. Cross-testing defined contribution plans is only the most recent, and often most dramatic, available tool to avoid proportionality. And we agree with Professor Zelinsky that attempts to ensure a significant measure of proportionality through new legislation will not find sufficient Congressional support. Even if they did, such gains would likely be short-lived. Ultimately, given the resourceful creativity of the pension consulting industry, new legislation of this sort would succeed only in bringing further complexity to the qualified plan area.

A minimum contribution regime, however, might command relatively broad political support as a legislative initiative, since it would relieve many firms of the planning and operational costs they pay today to avoid proportionate benefit levels for all employees. In exchange for this relief, firms would agree to provide minimum contribution levels for all employees. The size of such minimum contribution, although ultimately a matter of primarily political dimension, should be sufficient to justify the substantial tax expenditure that qualified plans impose. We would like to see an annual contribution set in a range of 5-10%, which seems reasonable given the under-saving of many baby boomers (the oldest of whom are now in their early fifties) and the likelihood of increased longevity for today's younger workers.

Unlike Professor Zelinsky, though, we would structure the minimum contribution differently, particularly if the

minimum contribution were not in the range we support. Rather than a straight contribution requirement, as Professor Zelinsky suggests,¹²⁰ we would structure a contribution requirement as a reverse match for an elective deferral arrangement, under which the maximum elective deferrals would be a multiple of the employer contribution.¹²¹ For example, the requirement might be that elective deferrals could be up to three times the firm's direct contributions. Thus, if the firm contributed 5% for each employee, any employee could make an elective deferral of up to 15% of compensation.

This approach has three advantages over a bare minimum contribution requirement. First, it locks no employee into a fixed level of qualified plan savings; individual rank-and-file employees could, as they now have the option to do through § 401(k) plans, save at the same rate as highly paid employees if they choose. Second, it retains a version of the proportional benefits model that in theory informs the current regulatory regime; the model ties the social benefit of a particular qualified plan¹²² in at least an approximate way to the size of the tax expenditures generated by that qualified plan. Third, to the extent the minimum contribution level is set higher than rank-and-file employees currently desire to save on their own, it provides incentives for the employer to educate

120. *Id.*

121. This idea is not original. A proposal that might be seen as its intellectual forbear was included in the 1989 report of the New York State Bar Association Special Committee on Pension Simplification, chaired by Alvin Lurie. The Committee proposed a plan in which employers would be required to make a base contribution for all employees, who could then make additional contributions. See New York State Bar Ass'n Special Comm. on Pension Simplification, *A Process Awry: Call for Simplification and Rationalization of the Federal Pension Laws*, reprinted in 8 AM. J. TAX POL'Y 75, 100-101 (1989). The idea of an explicit reserve match was proposed in 1997 by Senators Jeff Bingaman and James Jeffords. Their Pension ProSave Act, S. 957, 105th Cong. (1997), incorporated a proposal for a plan in which the employer would make an initial contribution of at least 1% of salary for each eligible employee. *Id.* § 101. Employees could then match the employer contribution by a two-to-one ratio. *Id.* The proposal had a \$6000 annual dollar limit. *Id.*

122. We would define the social benefit as the amount of retirement savings generated for middle and lower-income workers, who presumably are the intended beneficiaries of a paternalistic government policy to encourage savings. More affluent individuals have greater capacity to save and are less compelling candidates for government incentives to save for retirement.

employees about the value of saving for retirement through qualified plans.

The value of education in promoting retirement savings is worthy of further examination. Some supporters of new comparability plans, for example, argue that a minimum allocation of 5% of pay for rank-and-file employees would be welfare-reducing for such workers. In other words, rank-and-file employees would not be willing to accept a dollar-for-dollar reduction in cash compensation for contributions to a qualified plan amounting to 5% of pay. We assume that this is, in fact, currently the case in many situations.¹²³ Some recent economic work, however, suggests that the resistance of rank-and-file employees to qualified plan savings can be attenuated through employer initiatives, including education.¹²⁴ To the extent that legal requirements condition the provision of desired deferral levels for proprietary employees on the provision of similar deferral levels for other employees, they provide an important incentive for employers to educate employees and adopt plan design features that encourage increased levels of retirement savings. Moving from a proportionality nondiscrimination regime to a minimum contribution regime may, at the margin, undermine employer incentive to modify employee savings behavior by providing such education. Our proposal retains some incentive for firms to provide financial education to rank-and-file workers. Our proposal would also introduce considerable flexibility to the regulatory regime governing qualified plans, since integration and vesting rules could be dispensed with entirely.

123. One caveat is worth noting. The costs of non-wage compensation, such as pensions, will generally be reflected in wage compensation; but it is unclear whether such shifting occurs at the level of the individual worker, as opposed to large groups of workers or the firm's workforce as a whole. See, e.g., Jonathan Gruber, *Health Insurance and the Labor Market*, in 1A HANDBOOK OF HEALTH ECONOMICS (A. J. Culyer & Joseph P. Newhouse eds., 2000).

124. See generally PATRICK J. BAYER ET AL., THE EFFECTS OF FINANCIAL EDUCATION IN THE WORKPLACE: EVIDENCE FROM A SURVEY OF EMPLOYERS (Nat'l Bureau of Econ. Research, Working Paper No. 5655, 1996), available at <http://papers.nber.org/papers/w5655.pdf>; B. DOUGLAS BERNHEIM & DANIEL M. GARRETT, THE DETERMINANTS AND CONSEQUENCES OF FINANCIAL EDUCATION IN THE WORKPLACE: EVIDENCE FROM A SURVEY OF HOUSEHOLDS (Nat'l Bureau of Econ. Research, Working Paper No. 5667, 1996), available at <http://papers.nber.org/papers/w5667.pdf>.

We are not certain that a satisfactory version of this proposal should (and perhaps even could) be developed for defined benefit plans (except perhaps for cash balance plans). Defined benefit plans that provide for meaningful risk-shifting and that satisfy a meaningful permanence test are not troubling, at least from the policy perspective from which we have written this paper. Defined benefit plans that are temporal or fail to shift risk, however, should either be denied the tax benefits of the qualified plan regime or subjected to a minimum accrual requirement. If the latter approach were taken, plan benefits should be indexed to cost-of-living increases, including increases after an employee ceases to be covered by the plan. If not, such plans could continue to be used as devices to discriminate against younger rank-and-file employees, which ultimately is the core of the cross-testing controversy: introducing into defined contribution plans a problem previously confined to certain (but not all) defined benefit and target benefit plans.

CONCLUSION

The Treasury Department's proposed regulations limiting the use of cross-testing are a useful first step in curtailing the most egregious cases in which the basic intent of the nondiscrimination norm is violated. A similar case could be made for limiting the use of defined benefit plans in small firms, since a defined benefit format in such a setting often does not accomplish much of the risk-sharing inherent to larger defined benefit plans. Defined benefit plans in small firms often share many of the costs associated with cross-tested defined contribution plans, and lack the offsetting benefits of defined benefit plans in larger firms. Finally, we propose a broader reform of the nondiscrimination rules that would reduce complexity while remaining consistent with the fundamental goal of using the tax expenditures associated with qualified plans to promote retirement saving among lower- and middle-income workers.