

6-1-1976

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### Recommended Citation

David I. Halperin, *Retirement Security and Tax Equity: An Evaluation of ERISA*, 17 B.C.L. Rev. 739 (1976), <http://lawdigitalcommons.bc.edu/bclr/vol17/iss5/2>

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# RETIREMENT SECURITY AND TAX EQUITY: AN EVALUATION OF ERISA

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No one can be certain how long he can work, how long he will live after stopping work or about the cost of living at that time. Moreover, retirement seems so remote when one is young. For these and other reasons, it is unlikely that most individuals, left to their own devices, would provide for an adequate retirement income.<sup>1</sup>

At least a subsistence level of living for the working population is provided through Social Security.<sup>2</sup> While public policy appears to demand assurance of *continuity* in the worker's standard of living, Congress has not yet raised Social Security benefits to that level.<sup>3</sup> Rather, it has tried, through special tax benefits, to encourage the establishment of private pension plans to fill the gap.<sup>4</sup> The enactment of ERISA—the Employees Retirement Income Security Act of 1974<sup>5</sup>—reflects increased Congressional concern with the inadequacy of retirement income. This article explores the problems which led to ERISA and attempts to grade Congress on its achievement. Specific provisions of the Act will be discussed in detail only to the extent necessary to make the policy discussion intelligible.<sup>6</sup>

## I. INTRODUCTION

### A. *Tax Incentives—The Catalyst*

There is a dilemma in relying on purely voluntary, employer es-

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<sup>1</sup> See J. PECHMAN, H. AARON, M. TAUSSIG, *SOCIAL SECURITY PERSPECTIVES FOR REFORM* 61.

<sup>2</sup> 42 U.S.C. § 402 (1970), as amended, (Supp. IV, 1974).

<sup>3</sup> See Ball, *Social Security & Private Pension Plans*, 27 NAT'L TAX J. 467, 469 (1974). For a more complete discussion of the adequacy of Social Security to meet retirement needs, see Section VII of this Article.

<sup>4</sup> SENATE COMM. ON FINANCE, *PRIVATE PENSION PLAN REFORM* S. REP. NO. 383, 93d Cong., 1st Sess. 2 (1973) [hereinafter cited as SENATE REP.].

<sup>5</sup> 29 U.S.C. §§ 1001-1381 (Supp. IV, 1975) [hereinafter cited as ERISA].

<sup>6</sup> For details as to the operation and history of ERISA, see, e.g., Chadwick & Foster, *Federal Regulation of Retirement Plans: The Quest for Parity*, 28 VAND L. REV. 641 (1975); Goetz, *Income Tax Aspects of the New Pension Reform Law*, 1975 U. ILL. L. FORUM 143; Gunn, *Participation and Vesting Under the Employee Retirement Income Security Act of 1974*, 1975 U. ILL. L. FORUM 181; Herbert, *Investment Regulation and Conflicts of Interest in Employer-Managed Pension Plans*, 17 B.C. IND. & COM. L. REV. 127 (1976); Comment, *The Employee Retirement Income Security Act of 1974: Policies and Problems*, 26 SYR. L. REV. 539 (1975).

established pension plans to provide the level of retirement income public policy is felt to require. As the plans come closer to the ideal rather than what employers or employees perceive as in their respective interests, employers may have less interest in creating them.<sup>7</sup> Therefore, it is believed to be necessary to encourage sound programs by offering tax relief to those who establish them.<sup>8</sup>

The favorable treatment of pension plans under the Internal Revenue Code is limited to so-called qualified plans—plans that do not discriminate in favor of stockholders, officers, or other highly compensated employees.<sup>9</sup> This indicates that the purpose of the tax subsidy is to encourage plans for lower paid individuals, who are the ones unlikely to save on their own. The high paid employees are encouraged to provide for their retirement under arrangements which also benefit the low paid group.<sup>10</sup>

Prior to ERISA, it was not particularly difficult to defer taxation of compensation until after retirement, but in exchange the employer had to forego its tax deduction until the amount was included in the income of the employee.<sup>11</sup> In other words, if an employee earned \$100,000 in 1972 and the employer insisted on deducting the entire \$100,000 currently, the employee would have had to include \$100,000 in his income within a short time after the end of 1972.<sup>12</sup> If the employee arranged to defer tax on part of this compensation, to say 1980, then the deduction for this part would similarly be delayed until 1980.<sup>13</sup> Thus, compensation paid to employees is generally deductible by the employer only if the employee will include the payment in income at approximately the same time.

The only exception to this "matching" rule for compensation is for pension and profit-sharing plans that "qualify" under section 401 of the Internal Revenue Code. Contributions to such plans are deductible when made,<sup>14</sup> while taxation to the employee is *delayed* until actual *distribution*<sup>15</sup> from the plan, most often after retirement.

<sup>7</sup> See 26 SYR. L. REV., *supra* note 6, at 555.

<sup>8</sup> SENATE REP., *supra* note 4, at 18.

<sup>9</sup> INT. REV. CODE OF 1954, § 401(a)(4).

<sup>10</sup> See Statement of Frederic W. Hickman, then Ass't Sec'y of the Treasury for Tax Policy, from *Pension and Profit Sharing Plans: The Quintessential Tax Shelter* at 7, before the 25TH NAT'L CONF. OF THE TAX FOUNDATION (Dec. 5, 1973).

<sup>11</sup> The employee must also be willing either to take a forfeitable interest (such that his rights will be dependent on the performance of substantial future service) or to rely upon the credit of the employer. If he gets security for vested rights (for example, the employer makes deposits to a trust fund), then the employee will be immediately taxable even though distribution is delayed. INT. REV. CODE OF 1954, §§ 402(b), 83; Rev. Rul. 60-31, 1960-1 CUM. BULL. 174. See Section IV, Part A and Section VI, Part C, *infra*.

<sup>12</sup> A short period of deferral will not prevent deduction under INT. REV. CODE OF 1954, § 162. Such payments are not deferred compensation. See, e.g., Rev. Rul. 55-446, 1955-2 CUM. BULL. 531.

<sup>13</sup> INT. REV. CODE OF 1954, § 404(a)(5). But see *Latrobe Steel Co.*, 62 T.C. 456, 469 (1974).

<sup>14</sup> INT. REV. CODE OF 1954, § 404(a)(1), (2), (3).

<sup>15</sup> *Id.* § 402(a)(1).

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Deferral of taxation until after retirement can, of course, reduce the tax if the worker will be in a lower tax bracket in his post-retirement years. This is a possibility wherever compensation is deferred. Under a qualified plan, however, there is an advantage—to the parties—even when the tax bracket is not changed.

Thus, the mismatching of the employer deduction and the reporting of income enables the parties to increase the amount of money in private hands. For example, if a corporation which normally pays tax at the 48 percent rate earns \$10,000, it can retain \$5,200 after tax. If instead of keeping the \$10,000, the corporation paid it to Mr. Jones as compensation, Jones will be able to retain whatever portion is left after payment of his taxes. If Jones is also in the 48 percent bracket, he retains \$5,200. The amount of money in private hands is unchanged by the corporation's decision to pay Jones an extra \$10,000 in compensation.

On the other hand, if the \$10,000 were contributed to a qualified pension plan, the plan retains the full \$10,000, thus increasing the amount of money in private hands by \$4,800. The Treasury does not get this money until the plan distributes \$10,000 to Jones (assuming Jones remains in the 48 percent bracket at the time of distribution).

### B. Purpose of ERISA

Concern for equity in the distribution of the tax burden should have led to an examination of the amount of aid toward building a nest egg for retirement which is provided through the tax relief just described, as well as the number and income level of the workers receiving such aid.<sup>16</sup> But ERISA goes beyond the amendments to the Internal Revenue Code contained in Title II of the Act. Title I of ERISA regulates the terms and conditions of retirement programs, even if special tax relief is *not* sought. While not an exact duplicate, the provisions of Title I closely parallel those of Title II.<sup>17</sup>

If the decision to establish a plan is purely voluntary, why should there be any restriction on coverage or other conditions of operation? One reason is obvious. Once an employer establishes a plan, an employee can be expected to rely on it to provide for his retirement. If this reliance turns out to be unwarranted, the result can be cata-

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<sup>16</sup> See PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS ii (1965).

<sup>17</sup> 29 U.S.C. §§ 1051-1061, Tit. 1 Subtitle B, Part 2 (Supp. IV, 1975) (Participation and Vesting) has its counterpart in INT. REV. CODE OF 1954, §§ 401(a)(11), (12), (13), (14), (15), (19), 410, 411, 414. 29 U.S.C. §§ 1081-1086, Tit. 1 Subtitle B, Part 3 (Funding) has its counterpart in INT. REV. CODE OF 1954, § 412. Title I also has provisions relating to Reporting and Disclosure, ERISA §§ 101-111, 29 U.S.C. §§ 1021-1031 (Supp. IV, 1975) and Fiduciary Responsibility, ERISA §§ 401-414, 29 U.S.C. §§ 1101-1114 (Supp. IV, 1975). A detailed discussion of these latter provisions, which also have parallels in the Internal Revenue Code, *see, e.g.*, INT. REV. CODE OF 1954 §§ 4975, 6057, is beyond the scope of this Article.

strophic, much worse than if the employee expected to fend for himself. Educating employees to plan on the assumption the benefit might not be paid would defeat the purpose of private plans by causing double savings in many instances. Thus, ERISA is a kind of "truth in pension" Act. Employers should not be allowed to promise a pension unless there is fairly good assurance the promise will be kept.<sup>18</sup>

Thus, the success of ERISA can be measured by the answers to the following questions:

1. Will employees working for companies that maintain retirement programs be entitled to receive an annual benefit upon retirement?<sup>19</sup>
2. Will funds be available to pay such pension?<sup>20</sup>
3. What effect will ERISA have on the establishment and maintenance by employers of adequate retirement programs?<sup>21</sup>
4. Will workers who should not expect to receive an adequate pension through their employment be apprised of this early enough so they can save for retirement?<sup>22</sup>
5. Will it be realistic to expect such savings to take place?<sup>23</sup>
6. What is ERISA's effect on equity in the distribution of the tax burden?<sup>24</sup>

## II. COVERAGE OF EMPLOYEES IN ESTABLISHED PLANS

There are a multitude of reasons why employees of corporations with retirement programs may have found themselves without a pension at the time of retirement. These may be roughly classified as follows:

1. The employee's attachment to the corporation was not long enough, or it was sporadic rather than continuous.
2. The job classification in which the employee served was not covered by the plan. It was common practice for plans to differentiate between members of an affiliated group of corporations, between separate divisions of one corporation, and even between hourly and salary employees of one division. Furthermore, ordinarily part-time or seasonal employees were not given pension coverage.
3. The employee's salary was not high enough—the pension plan was "integrated" with social security and pro-

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<sup>18</sup> The objective of ERISA is "to assure 'that American workers who are promised retirement benefits will actually get what they have coming.'" Sen. Harrison J. Williams (D.N.J.) as quoted in the *Wall St. J.*, Aug. 28, 1974, at 1, col. 6.

<sup>19</sup> See Section II *infra*.

<sup>20</sup> See Section III *infra*.

<sup>21</sup> See Section IV *infra*.

<sup>22</sup> See Part A of Section V *infra*.

<sup>23</sup> See Part B of Section V *infra*.

<sup>24</sup> See Section VI *infra*.

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vided benefits only on earnings not covered by social security.

4. The employee was not willing to contribute to the plan, or if he did contribute, to leave his money until retirement. In certain cases, employees would have a choice of current compensation, or a pension, and would choose the former.
5. Distribution from the plan was in a lump sum on termination from service or otherwise, rather than in an annuity or other installment after retirement.

Part A of this Section will discuss whether length of service should be taken into account in determining the employee's right to a pension, and if so, to what extent. Part B considers whether tax equity requires that employers be precluded from making the distinctions described in paragraphs 2 through 4 above. Part C discusses prospects that an accumulated pension will actually provide income during retirement. In summary, this section deals with the chances that employees of corporations that have established pension plans will be entitled to receive an annual payment after retirement.

### A. *Employees' Attachment to the Corporation—Vesting*

Vesting is the right of a plan participant to receive his accrued benefits, even though his employment is terminated before he is eligible for retirement. Generally, this right was provided only under certain circumstances—after a specified period of service, upon attainment of a specified age, or both, or upon specified types of termination. Thus, prior to ERISA, many plans required employees to work until age 55, or even age 60 or 65, in order to receive a pension.<sup>25</sup>

Obviously, many employees were frustrated in their expectation of a pension, and Title I seems intended to require that employees receive what they reasonably expect.<sup>26</sup> It is also conceivable that delayed vesting could result in an inequitable distribution of the tax benefits of qualified plans. This would be the concern of the vesting pro-

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<sup>25</sup> For summaries of congressional findings as to the conditions required for vesting prior to ERISA, see, e.g., SENATE REP., *supra* note 4, at 45; SENATE COMM. ON LABOR & PUBLIC WELFARE, STATISTICAL ANALYSIS OF MAJOR CHARACTERISTICS OF PRIVATE PENSIONS, 93d Cong., 2d Sess., reprinted in *Panel Discussions on General Tax Reform Before the House Comm. on Ways & Means*, 93d Cong., 1st Sess., pt. 7, at 1035 (1973) [hereinafter cited as *Panel Discussions*]; SENATE COMM. ON LABOR & PUBLIC WELFARE, SUBCOMM. ON LABOR, INTERIM REPORT OF ACTIVITIES OF THE PRIVATE WELFARE AND PENSION PLAN STUDY 1971, S. REP. NO. 634, 92d Cong., 2d Sess. 16 (1972).

<sup>26</sup> Congress heard a number of "horror" stories from workers who were denied pensions after long periods of service. See, e.g., 1971 INTERIM REPORT, *supra* note 25, at 68. There are those who believed that the statistics used by Congress were outdated and that the "horror" stories were the exception rather than the rule. Nevertheless, congressional action was needed to deal with those plans that did not measure up. See *Panel Discussions*, *supra* note 25, at 1089 (testimony of Prof. Dan M. McGill, Chairman of the Pension Research Council, Wharton School, University of Pennsylvania).

visions of Title II—section 411 of the Internal Revenue Code.

### 1. Selection of Vesting Standard

#### (a) *Factors to be considered*

Some would argue for full and immediate vesting.<sup>27</sup> The existence of an employer financed pension plan presumably causes wages to be lower than they otherwise would be. The contribution to the pension plan is really the employee's money and he should obtain it eventually. Moreover, unless there is immediate vesting employees who change jobs frequently cannot hope to build up an adequate pension. What can be said in opposition to this position?

Intentionally delaying vesting to reduce employee turnover and labor mobility is presumably contrary to public policy.<sup>28</sup> ERISA's sanction of so-called "class year plans" under which even long-service employees may always have a forfeitable interest in contributions for the last five years<sup>29</sup> is unfortunate, particularly in the absence of any discussion of how public policy is served by such plans.<sup>30</sup>

Very rapid vesting could be opposed on the grounds that administrative costs would be unduly high in relation to the benefit. Although the validity of this argument is uncertain, it seems nonetheless clear that it would not justify the period of delay permitted by ERISA.

Some argued that vesting should not be mandated because it is expensive. If money is paid out or set aside for people who leave before retirement, there will not be enough left for an adequate retirement benefit for those who remain.<sup>31</sup> Particularly in new plans it is advisable to let the employer focus entirely on those close to retirement, who need a pension most, rather than dissipating assets in favor of terminating employees. Once the plan is in operation for a substan-

<sup>27</sup> Remarks by Ralph Nader before the Association of Private Pension and Welfare Plans, Inc. (1971); *Hearings on Tax Proposals Affecting Private Pension Plans Before the House Comm. on Ways & Means*, 92d Cong., 2d Sess., pt. 3, at 847 (1972) (statement submitted by Professor Barry Bressler) [hereinafter cited as *Hearings*].

<sup>28</sup> See PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 40 (1965); *Hearing on S. 3421 Before Subcomm. on Labor of the Sen. Comm. on Labor & Public Welfare*, 90th Cong., 2d Sess. 249 (statement of Thomas R. Donahue, Ass't Sec'y of Labor, Exhibit B). *But see*, FOLK, PRIVATE PENSION AND LABOR MOBILITY, JOINT ECONOMIC COMMITTEE, OLD AGE INCOME ASSURANCE, PART IV: EMPLOYMENT ASPECTS OF PENSION PLANS, 90th Cong., 1st Sess. 132, 134-35 (1967).

<sup>29</sup> ERISA § 203(c)(3), 29 U.S.C. § 1053(c)(3) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(d)(4).

<sup>30</sup> The special treatment for class year plans apparently had its origins in the bills developed by the Senate Comm. on Labor & Public Welfare. See RETIREMENT INCOME SECURITY FOR EMPLOYEES ACT OF 1973 S.4, S. REP. NO. 127, 93d Cong., 1st Sess. 123 (1973) (§ 202(a)(3) of the bill).

<sup>31</sup> See *Hearings*, *supra* note 27, pt. 3, at 819 ("Benefit Plan Bulletin" prepared by Johnson & Higgins).

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tial period of time, it will improve benefits and can then institute vesting.<sup>32</sup> If people who assert that pensions are deferred wages are correct, however, this is the equivalent of saying, "I can't pay B what he has earned, because if I do, I would not have enough to pay A what he needs to live." Employers sought to rebut the deferred wage assertion by pointing out that contributions are generally not allocated to particular employees.<sup>33</sup> Rather, the assumption is that, due to mortality and turnover, not everyone will collect a pension.

Although the reference to individual allocation is simplistic, this reasoning does suggest what seems to be the most serious argument for delayed vesting, namely, that perhaps the wage structure is such that the cost of pensions is borne by long-service and older employees. Younger employees, who do not think about retirement must be paid their value in cash or they will not accept the job.<sup>34</sup> It may also be possible that the wage level of newer employees would be too high if it included a pension because the wage structure does not reflect training costs. This excess could be recaptured on early termination of employment through forfeiture of the pension.<sup>35</sup>

Furthermore, uncertainty about who actually bears the cost of pensions could be resolved in favor of an age requirement for vesting, on the theory that younger employees will get other jobs or will otherwise be able to make arrangements for retirement.<sup>36</sup> Some companies do provide a pension, intended to permit a reasonable living standard above subsistence, for employees with as little as 15 years of service.<sup>37</sup> Moreover, even if an individual could not earn a full pension elsewhere, the loss of benefits based on his salary at age 25 or 35 will be relatively meaningless if wages are continually rising.<sup>38</sup> The pension earned in the last 20 years of employment will, assuming no change in employment status, provide substantially all of his retirement income.<sup>39</sup> Arguments such as these may have led the Nixon

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<sup>32</sup> *Id.* at 818.

<sup>33</sup> See e.g., *Hearings, supra* note 27, pt. 3, at 593 (testimony of John A. Cardon on behalf of Ad Hoc Corporate Pension Fund Committee).

<sup>34</sup> McClung, *The Economics of Pension Finance*, 36 J. OF RISK & INS. 425 (1969).

<sup>35</sup> FOLK, *supra* note 28, at 145.

<sup>36</sup> See *Panel Discussions, supra* note 25, at 1097 (statement of Dan M. McGill). An objection to age related vesting is that it could cause employment discrimination against older workers. See *Hearings, supra* note 27, pt. 2, at 404 (testimony of Andrew J. Biemiller representing the AFL-CIO). But see *id.* pt. 1, at 74 (testimony of Edwin S. Cohen, Ass't Sec'y of the Treasury for Tax Policy).

<sup>37</sup> Many plans have an alternative pension formula of say 40% of pay including social security which will be payable to all employees with 15 or more years of service. On the other hand, according to a recent survey, nearly 80% of all plans have no limit on credited service and almost all give credit for at least 30 years. BANKERS TRUST CO., 1975 STUDY OF CORPORATE PENSION PLANS.

<sup>38</sup> *Hearings, supra* note 27, pt. 2, at 431 (statement of Quentin I. Smith, Jr., President of Towers, Perrin, Forster & Crosby, pension consultants).

<sup>39</sup> An employee hired at age 25 at \$5,000 per year, who receives a salary increase of 4% to 7% per year and obtains new employment at age 35, 45 and 55 will probably receive 70% to 80% of his accrued pension even if the pension earned in the first two



Administration to propose a "rule of 50:" Fifty percent vesting at the point where age and participation in the plan (which was delayed until age 30 and 3 years of service) total 50 years, with the vested percentage increasing 10 percent a year for the next 5 years.<sup>40</sup>

While the argument that age was significant always had some appeal to me, I felt that the difference in treatment between older and younger employees under the Administration proposal was too great. The fact that full pensions are not normally earned after only 15 or 20 years<sup>41</sup> should make one wary of the argument that younger people do not bear the cost of the plan. Moreover, even the loss of a pension earned while young could be serious, particularly to those who suffer a career setback and do not experience rapidly rising income or steady employment. I had suggested that as a compromise, 50 percent vesting be required when an employee has completed 10 years of service or reaches age 45 after 5 years of service, whichever comes first.<sup>42</sup>

(b) *Evaluating the ERISA Solution*

ERISA resolved the debate over age as a factor in vesting by allowing the employer a choice of whether to take age into account. However, the age-related standard allows age to be considered to a much lesser extent than its supporters desired.

A plan may adopt one of three minimum vesting schedules:<sup>43</sup>

- (i) A five-to-fifteen year "graded" vesting schedule, under which an employee's accrued benefit will be 25 percent vested after five years' service, 50 percent vested after 10 years' service and 100 percent after 15 years' service;
- (ii) "Cliff" vesting under which an employee's accrued benefit will be 100 percent vested after ten years' service; or
- (iii) A "rule of 45" under which the accrued benefit of an

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jobs were forfeited. Some believed that this problem could be alleviated by the transfer of a sum equal to the value of the employee's accrued benefit to a central fund. See S. REP. *supra* note 4, 71-78 (description of "Portability"). This would work only if inflation caused the value of the fund to grow sufficiently to keep pace with increases in salary.

<sup>40</sup> See Message from President Richard M. Nixon (Dec. 8, 1971) reprinted in *Hearings, supra* note 27, pt. 1, at 6, 9. Since the Nixon proposal permitted all service prior to age 30 to be excluded, vesting would not have been required prior to age 40 even if a person began work at age 18 and had 21 years of service at age 39. Further, since the first 3 years of service could be excluded, under the proposal full vesting could not occur prior to age 45 with at least 18 years of service at that point. Explanation of H.R. 12272, The "Individual Retirements Benefits Act of 1971," *id.* at 23, 24-25.

<sup>41</sup> See note 37 *supra*.

<sup>42</sup> See *Panel Discussions, supra* note 25, at 1135 (statement of Daniel Halperin).

<sup>43</sup> ERISA § 203(a)(2), 29 U.S.C. § 1053(a)(2) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(2).

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employee with five or more years of service will be 50 percent vested when his age and years of service equal 45, and another 10 percent will vest in each of the following five years. However, under this schedule the benefits of an employee with 10 years of service must be at least 50 percent vested and an additional 10 percent must vest for each additional year of service.

In sum, ERISA requires full vesting after a period of service no longer than 15 years. This can occur on an all-or-nothing basis after 10 years of service. The price of delaying full vesting 5 more years is the institution of partial vesting beginning after 5 years of service either at 25 percent for all employees under the first alternative, or at 50 percent only for older workers under the "rule of 45." Can this be considered a successful solution to the vesting problem?

If the goal is relatively universal coverage by the private retirement system, it would seem that the period of service required before vesting takes effect should be short enough to make it likely that any employee who has an average experience in changing jobs will earn vested benefits for at least a significant portion of his working career. However, this goal is hard to reconcile with a voluntary system which permits an employer not to have a plan unless he so chooses. Vesting seems required under a voluntary system only to avoid hardship to those who did not understand the conditions for vesting and relied on the plan to their detriment. This rationale might suggest that once a significant accrued benefit has been earned under a plan, it should not be lost for lack of vesting. The only alternative would be to improve the information to employees so that they will more fully understand the risks they are taking.<sup>44</sup> It was stated above that the purpose of the private pension system would be defeated if employees covered by plans had to save as if no pension would be forthcoming.<sup>45</sup> However, this is less of a problem if those who forfeit benefits are younger employees who did not have their wages reduced because of the existence of a plan, at least if during the period of accrual they would not have ordinarily saved for retirement. Retirement savings for these people would come later on in life either from an employer plan or individually. Vesting would be required only for benefits accrued during the period when savings for retirement can be expected and are reflected in the wage structure.

Tax relief, however, represents the expenditure of public funds and it is reasonable to insist that the beneficiaries of such funds act in a manner consistent with public policy. Vesting, prior to retirement, has always been insisted upon by the Internal Revenue Service when and to the extent it felt it to be necessary to prevent a plan from dis-

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<sup>44</sup> See Section V, Part A, *infra*.

<sup>45</sup> See text at note 18 *supra*.

criminating in favor of higher paid employees.<sup>46</sup> Insertion of a specific vesting standard into the Code could indicate that the administrative practice was insufficient to secure adequate pension coverage for low paid workers or that tax equity requires extension of the benefits provided by qualified plans to shorter-service employees whether or not these people are earning less than longer-service workers. It seems reasonable to assume that we are trying through the tax law to provide protection for people who would not independently save. Thus, the right question may be—is the accrued benefit important in providing for the individual's retirement? Or at least, does the wise expenditure of tax funds depend upon the "purchase" of that benefit? If so, vesting should be required.

These are matters of judgment which I might hesitate to exercise even if I had all the data I would desire at my disposal. Certainly, in the absence of more complete information as to how wages are set and the appropriate period for retirement savings, it is difficult to evaluate ERISA's achievement. I believe, however, that ERISA falls short of the ideal. Employees hired at advanced ages are certainly going to be within the appropriate period for retirement savings before 10 years have passed. Younger workers are likely to reach this stage within 15 years. Nevertheless, in defense of the legislation it should be noted that ERISA compares favorably with the vesting standard urged by any Administration or legislative committee which studied the issue in depth.<sup>47</sup> These groups may have been proposing what they believed to be "practical" rather than "ideal." This suggests that Congress may be prepared to provide greater protection if the proper case can be made.

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<sup>46</sup> See text at note 48 *infra*.

<sup>47</sup> 1965: The President's Committee on Corporate Pension Funds recommended 50% vesting after 15 years of service with full vesting after 20 years. PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 42.

1968: The Inter-Agency Task Force which produced the 1965 Report was reconstituted and developed a bill sponsored by the Department of Labor, S. 3421 introduced on May 2, 1968. This bill provided for full vesting with 10 years of continuous service after age 25. See *Hearings on S. 3421 Before the Subcomm. on Labor of the Comm. on Labor & Public Welfare*, 90th Cong., 2d. Sess. 220-21 (statement of Thomas R. Donahue, Ass't Sec'y of Labor).

1971: S. 2 introduced by Senator Javits—10% vesting after six years of plan service, increasing 10% per year to full vesting after 15 years of participation.

1971: Nixon Administration recommends rule of 50. See note 40 *supra*.

1973: S. 4 as reported by the Committee on Labor & Public Welfare provided for 30% vesting after 8 years of plan service increasing 10% per year to full vesting after 15 years of participation. See § 202(a)(1) of the bill. S. REP. NO. 127, 93d Cong., 1st Sess. 122 (1973).

Moreover, many of these proposals had transitional rules far longer than that permitted under ERISA.

(c) *Vesting and Discrimination*

(i) *Prior Law*

As stated above, favorable tax treatment for qualified plans is supported as a means of developing pension coverage for a wide range of employees who otherwise might not be expected to have adequate savings. Thus, the Internal Revenue Code requires that plans not discriminate in favor of the higher paid. Obviously, this discrimination could occur in practice even under plans in which all employees participated, if there were more rapid turnover among the low paid group and the vesting standard was such that fewer low paid employees actually qualified for a pension. Accordingly, the Internal Revenue Service insisted that "vesting provisions in a qualified plan . . . not result in the discrimination prohibited by . . . the Code," as determined by the facts in each case.<sup>48</sup>

According to the Conference Committee Report on ERISA, "the law in this area has been administered on a case-by-case basis without uniform results in fact situations of a similar nature."<sup>49</sup> One witness, who agreed with this statement, testified that in Delaware closely-held companies were often required to provide full vesting after 5 years of employment.<sup>50</sup> Practitioner complaints about this lack of uniformity were apparently widespread.<sup>51</sup>

Instead of trying to develop procedures to assure more uniform treatment, the Treasury asked Congress to impose limits on its discretion to require vesting in order to prevent discrimination. Under the original Administration proposal full vesting could not be required in less than 6 years, for employees hired at age 35 or later, and could take much longer for younger employees, for example 12 years, if the age at hire were 25.<sup>52</sup>

(ii) *The Effect of ERISA*

The Code now provides that compliance with the minimum vesting standard of ERISA, even though it is much less stringent than

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<sup>48</sup> Rev. Rul. 71-151, 1971-1 CUM. BULL. 123.

<sup>49</sup> Employee Retirement Income Act of 1974, H.R. REP. NO. 1280, 93d Cong., 2d Sess. 276 (1974).

<sup>50</sup> *Panel Discussions*, *supra* note 25, at 1152 (testimony of Converse Murdoch).

<sup>51</sup> See SENATE REP., *supra* note 4, at 47.

<sup>52</sup> See Explanation of H.R. 12272, reprinted in *Hearings*, *supra* note 27, at 27. The strictest vesting standards permitted were those imposed on plans benefitting self-employed individuals who are owner-employees. *Id.* at 31. This was a "rule of 35" so that 50% vesting would be required when age plus participation equals 35 with full vesting 5 years later. *Id.* at 30. Employees hired at age 35 would become participants after 1 year, *id.* at 28, and would be 50% vested immediately leading to full vesting after 6 years. Employees hired at age 25 would become participants after 3 years. *Id.* At age 32, 7 years after hire, such employees would have 4 years of participation and would be 50% vested. Full vesting would come at age 37.

that previously required by the IRS, would be sufficient to satisfy any anti-discrimination test unless:

- (A) there has been a pattern of abuse under the plan (such as a dismissal of employees before their accrued benefits become non-forfeitable)<sup>53</sup> tending to discriminate in favor of employees who are officers, shareholders or highly compensated, or
- (B) there have been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders or highly compensated.<sup>54</sup>

This last provision could be interpreted to describe prior practice, thus rendering the amendment totally innocuous. However, the Committee Report states:

[E]xcept in cases where actual misuse of the plan occurs in operation, the Internal Revenue Service is directed not to require a vesting schedule more stringent than 40 percent vesting after 4 years of employment with 5 percent additional vesting for each of the next 2 years, and 10 percent additional vesting for each of the following five years. Also, this more rapid vesting would generally not be required except in a case where the rate of likely turnover for officers, shareholders or highly compensated employees was substantially less (perhaps as much as 50 percent less) than the rate of likely turnover for rank-and-file employees. . . . It generally is not intended that any plan (or successor plan of a now existing plan) which is presently under a more rapid vesting schedule should be permitted to cut back its vesting schedule as a result of this statement.<sup>55</sup>

The Internal Revenue Service first announced in Revenue Procedure 75-49 that in the absence of so-called "4-40 vesting", the most stringent the Conference Report would permit, it would not issue advance determination letters as to compliance with the non-discrimination requirement if the turnover rate of the rank-and-file employees was more than 6 percent per year and more than 200 percent of the turnover rate of the so-called "prohibited group" (shareholders, officers and highly paid).<sup>56</sup> However, "comments received by the Service suggest[ed] that a large number of employers may not" be able to meet the turnover test and thus would be forced

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<sup>53</sup> Title I makes it unlawful to discharge a participant "for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan." ERISA § 510, 29 U.S.C. § 1140 (Supp. IV, 1975).

<sup>54</sup> INT. REV. CODE OF 1954, § 411(d)(1).

<sup>55</sup> H.R. REP. NO. 1280, 93d Cong., 2d Sess. 276-77 (1974).

<sup>56</sup> Rev. Proc. 75-49, 1975 INT. REV. BULL. NO. 48, at 34.

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to adopt "4-40 vesting."<sup>57</sup> Responding to these complaints, the Internal Revenue Service announced it was reconsidering its position and that meanwhile applicants for advance determination letters could demonstrate compliance with the non-discrimination standard on the basis of a prior favorable ruling or by application of the facts and circumstances test utilized by the Service prior to ERISA.<sup>58</sup> The Internal Revenue Service also stated that it would not require a vesting schedule more rapid than "4-40 vesting" unless there is a pattern of abuse under the plan.<sup>59</sup>

It appears from the controversy surrounding the issuance of Revenue Procedure 75-49 that application of the turnover test suggested in the Committee Report could lead to imposing 4-40 vesting as a minimum standard in almost all cases. This would be substantially more stringent than the statutory tests of ERISA. On the other side, if 4-40 vesting were the *maximum*, many closely-held companies would be able to lengthen the period for vesting over what had previously been required by the Service. The latest Internal Revenue Service pronouncement indicates that, despite the Committee report language to the contrary, it would allow such plans to be amended.

### (iii) Evaluation

It should go without saying that it would be ironic for an "Employee Retirement Income Security Act" to be the vehicle for *dilution* of protection heretofore afforded by administrative practice. Uniformity in treatment throughout the country is a worthwhile goal but it is a poor excuse for denial of vesting to the extent previously required. Nor is there much of an argument that prior practice discriminated against small corporations. Shorter vesting periods in owner-dominated plans are justified by the fact that the owner himself is "immediately" vested in his benefit, since he controls the business and thereby is virtually certain to remain employed as long as the business is in existence. Thus, use of 4-40 vesting *as a maximum* is outrageous and "legislation" by Committee report makes it even more so. It would seem that any attempt by a corporation to lengthen its vesting standard, or adoption of 4-40 vesting by similarly situated companies, should provide a perfect test for the new procedure whereby an affected employee can ask the Tax Court for a declaration that the Internal Revenue Service issuance of a favorable determination letter to the employer was improper.<sup>60</sup>

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<sup>57</sup> T.I.R. 1424 (Dec. 9, 1975), 6 P-H 1976 FED. TAXES ¶54816.

<sup>58</sup> Rev. Proc. 76-11, 1976 INT. REV. BULL. NO. 9, at 22. See also T.I.R. 1441 (Feb. 2, 1976), 6 P-H (1976) FED. TAXES ¶54976.

<sup>59</sup> Rev. Proc. 76-11, Sec. 3.04, 1976 INT. REV. BULL. NO. 9, at 22, 23.

<sup>60</sup> INT. REV. CODE OF 1954, § 7476. To the extent ERISA will shorten the period of service required for eligibility it will have a cost impact for plans which already have 5-year vesting. More short-service employees will earn a vested benefit. Those plans which are funded by individual insurance contracts may suffer an increased cost due to

Application of 4-40 vesting as a minimum raises more difficult questions. As indicated above, I believe ERISA's vesting provisions do not assure equity in the distribution of tax relief for retirement savings. Nevertheless, the specific rules of ERISA would seem to represent current congressional judgment concerning the requirement of tax equity, at least as between short and long service employees. Congress did indicate a concern that the statutory rules might not offer sufficient protection against discrimination in favor of the highly-paid. This may, however, have been in the context of non-interference with prior practice of the Internal Revenue Service rather than a suggestion that new standards be applied. Moreover, Congress directed a study of the interrelationship of the vesting and anti-discrimination requirements<sup>61</sup> and requested the Treasury to supply information with respect to "patterns of benefit loss for different categories of plans . . . under the minimum vesting schedules prescribed"<sup>62</sup> by ERISA.

In these circumstances, it seems difficult to interpret ERISA as requiring a large number of plans to adopt more stringent vesting than that previously demanded by the Internal Revenue Service or specifically required by statute. Certainly, the Internal Revenue Service should not become more lenient and it should be more diligent than it has been in uncovering unusual disparities in turnover between the rank-and-file and highly paid groups. Moreover, I would not want to suggest that ERISA precludes more stringent rules across-the-board if, as the outcry to Revenue Procedure 75-49 indicates, the Internal Revenue Service was not sufficiently vigilant in preventing substantial discrimination against the rank-and-file. Nevertheless, Congress stated it wanted the matter *studied*, which would dictate that if the legislature is not the appropriate forum at least the more formal process required for the adoption of regulations should be utilized.<sup>63</sup>

## 2. Protection of a Vesting Standard

### (a) *Computation of Vested Benefit*

A full vesting of accrued benefit after no longer than 15 years of service would be an empty achievement if the benefit being earned during that period had no relation to the amount paid to those who stayed on until retirement.

ERISA permits the plan to base the benefit upon participation in the plan, but, in general, only allows an employee to be excluded

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the front-end load on contracts which are cancelled without providing vested benefits.

<sup>61</sup> ERISA § 3022(a)(1), 29 U.S.C. § 1222(a)(1) (Supp. IV, 1975).

<sup>62</sup> H.R. REP. NO. 1280, 93d Cong., 2d Sess. 277 (1974).

<sup>63</sup> T.I.R. 1441, *supra* note 58, states that any new general guidelines "will be published first in proposed form with full opportunity for public comment."

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from the plan for a relatively short time, no more than 18 months after date of hire or 6 months after attainment of age 25, whichever comes later.<sup>64</sup>

The Act seeks to insure that the benefit will be earned fairly ratably over the period of participation, and not too heavily in the years immediately preceding retirement.<sup>65</sup> An analysis of these provisions is beyond the scope of this article, but I venture an uncertain opinion that the vesting standard has not been significantly compromised by permitting the benefit earned in the later years of employment to be substantially greater than the benefit earned while young.

It is disturbing, however, that plans to which employees contribute do not appear to require ratable accrual of the benefit derived from employer contributions.<sup>66</sup> Apparently, it is possible to arrange employee contributions so that the employee pays for all or a large part of the benefit in the initial years of employment.<sup>67</sup> Although the employee would be 100 percent vested in his own contributions, he would have little or no rights to amounts set aside by the employer.

### (b) *Measuring the Period of Service—Continuity*

Under ERISA an employee is credited with a year of service for vesting purposes for any calendar or other plan year in which he has 1,000 hours of service.<sup>68</sup> Certain years may be disregarded, namely:

- (i) Years of service completed before the employee attains age 22;<sup>69</sup>
- (ii) Periods for which the employee failed to contribute to a plan requiring employee contributions;<sup>70</sup>

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<sup>64</sup> ERISA § 202(a)(4), 29 U.S.C. § 1052(a)(4) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 410(a)(4), requires participation to begin no later than 6 months after the employee first satisfies the eligibility conditions. Under ERISA § 202(a)(1)(A), 29 U.S.C. § 1052(a)(1)(A) (Supp. IV, 1975), INT. REV. CODE OF 1954, § 410(a)(1)(A), the general eligibility conditions are age 25 and 1 year of service. ERISA § 202(a)(1)(B), 29 U.S.C. § 1052(a)(1)(B) (Supp. IV, 1975), INT. REV. CODE OF 1954, § 410(a)(1)(B) permits more stringent eligibility conditions for certain plans which have very rapid vesting.

<sup>65</sup> ERISA § 204, 29 U.S.C. § 1054 (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(b).

<sup>66</sup> ERISA § 204(c)(2), (3), 29 U.S.C. § 1054(c)(2), (3) (Supp. IV 1975); INT. REV. CODE OF 1954, § 411(c).

<sup>67</sup> For example, the cost of a benefit equal to 1% of current compensation is, assuming an 8% interest rate, less than 1% of pay for an employee age 40. Assuming a 5% interest rate it is still less than 2% of pay for an employee aged 35. (These computations assume no turnover and use the 1951 Group Annuity Mortality Table.)

<sup>68</sup> ERISA § 203(b)(2)(A), 29 U.S.C. § 1053(b)(2)(A) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(5)(A).

<sup>69</sup> ERISA § 203(b)(1)(A), 29 U.S.C. § 1053(b)(1)(A) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(4)(A).

<sup>70</sup> ERISA § 203(b)(1)(B), 29 U.S.C. § 1053(b)(1)(B) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(4)(B).



(iii) Periods in which no employee accrues benefits under the plan.<sup>71</sup>

In addition, in certain circumstances service must be continuous to be fully counted.<sup>72</sup> Under the so-called "rule of parity," non-vested participants lose all claim to their prior service once they have been away from the employer for a consecutive period equal to their prior service.<sup>73</sup> Further, in the case of profit-sharing, money-purchase and certain plans funded by insurance contracts, years of service following a one-year break-in-service do not have any impact on the vesting of accrued benefits earned prior to the break.<sup>74</sup>

The only argument for delayed vesting which could justify ignoring periods prior to the time the plan came into existence or during which the employee declines to contribute is the claim that vesting should not be required for small amounts because administrative costs would outweigh the benefit to the employee. On balance, this seems an insufficient justification.

In the absence of ERISA, many employees were surprised to learn they were not entitled to a pension because of their failure to meet very stringent requirements as to continuity of service.<sup>75</sup> These rules were confusing to employees and could certainly interfere with reasonable expectations. Moreover, aside from the possible difficulty of maintaining records, it is hard to justify any requirement that service be continuous. The size of the accrued benefit for a given period of service can be the same whether or not the service is continuous. Conceivably the effect of the existence of the pension on current wages or the relationship between current wages and value of work will not be affected by a break-in-service unless it is so long that the two periods of work are totally unconnected. Thus, ERISA obviously had to have some restrictions on plan requirements for continuous service. The rule of parity may strike a reasonable balance between the need to prevent employee confusion and the employer's ability to

<sup>71</sup> The rule is stated in terms of years of service for periods during which the employer does not maintain the plan. ERISA § 203(b)(1)(C), 29 U.S.C. § 1053(b)(1)(C) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(4)(C). An employer is treated as maintaining a plan if any employee accrues benefits. ERISA § 204(f), 29 U.S.C. § 1054(f)(Supp. IV, 1975).

<sup>72</sup> ERISA § 203(b)(1)(D), 29 U.S.C. § 1053(b)(1)(D) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(4)(D).

<sup>73</sup> ERISA § 203(b)(3)(D), 29 U.S.C. § 1053(b)(3)(D) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(6)(D).

<sup>74</sup> ERISA § 203(b)(3)(C), 29 U.S.C. § 1053(b)(3)(C) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(6)(C). A one-year break-in-service is a calendar or other plan year during which the participant does not complete more than 500 hours of service. ERISA § 203(b)(3)(A), 29 U.S.C. § 1053(b)(3)(A) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(6)(A).

<sup>75</sup> See, e.g., *Hearings on S. 3421, supra* note 47, at 242-43 (Exhibit A-13); *Hearings on Examination of Private Welfare and Pension Plans Before the Subcomm. on Labor of the Sen. Comm. on Labor & Public Welfare*, 92d Cong., 1st Sess. 116 (1971) (Letter date April 6, 1971). See, Comment, *The Employee Retirement Income Security Act of 1974: Policies and Problems*, 26 SYR. L. REV. 539, 563 (1975).

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maintain records of prior employment with the corporation or any affiliate.<sup>76</sup> Nevertheless, a change should be considered if and when a recordkeeping difficulty cannot be substantiated.

Employers presumably sought the right to freeze any forfeiture of accrued benefits under defined contributions plans at the time of separation from service, even if the employee returns to the job, because the separate accounts for each participant, required under such plans,<sup>77</sup> made it difficult to resurrect prior funding for the forfeited benefit. In the case of a profit-sharing plan, amounts forfeited were probably credited to the accounts of other participants.<sup>78</sup> Under money-purchase plans, forfeitures would reduce future employer contributions, as they would under any defined benefit pension plan.<sup>79</sup> Unlike defined benefit plans, however, money purchase plans might require an immediate additional contribution equal to the prior forfeiture in order to restore the account balance of the returning employee.

Nevertheless, it might have been better to seek ways and means to alleviate the employer's possible funding difficulty rather than to deprive the employee of benefits. Nor does a profit-sharing plan provide a more appealing case for forfeiture unless it is believed to be important to encourage allocation of forfeitures to the accounts of the remaining participants.<sup>80</sup> If forfeitures under a profit-sharing plan are applied to reduce future employer contributions, as they may be,<sup>81</sup> the situation does not differ from that of a money-purchase plan.

### (c) *Obtaining the Vested Benefit*

Under ERISA, unless a participant otherwise elects, payments of a benefit must begin shortly after the latest of age 65, the tenth anniversary of the commencement of participation, or the termination of service.<sup>82</sup> If the plan provides for an early retirement benefit, employees who terminate after having satisfied the service requirement for early retirement must be granted the right to receive benefits at the early retirement age.

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<sup>76</sup> See PRIVATE PENSION TAX REFORM, H.R. REP. NO. 779, 93d Cong., 2d Sess. 16 (1974) [hereinafter cited as HOUSE REP.].

<sup>77</sup> For a description of defined contribution plans, see, Section III, Part A *infra*.

<sup>78</sup> See Treas. Reg. § 1.401-4(a)(1)(iii) (1963).

<sup>79</sup> Treas. Reg. § 1.401-1(b)(1)(i) (1972).

<sup>80</sup> The President's Comm. on Corporate Pension Funds recommended that re-allocation of forfeitures be prohibited because of the danger that "all contributions may ultimately redound to the benefit of a relatively few long-term employees." PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 68 (1965).

<sup>81</sup> Rev. Rul. 71-313, 1971-2 CUM. BULL. 203.

<sup>82</sup> ERISA § 206(a), 29 U.S.C. § 1056(a) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 401(a)(14).

Protection against a participant losing track of a vested benefit is provided by coordination with the Social Security system. The employer is required to supply data to the Social Security Administration whenever an employee separates from service with a vested benefit.<sup>83</sup> When a person files for benefits, the Social Security Administration will give him any information it has concerning his right to a private pension.<sup>84</sup>

A plan also is required to establish a procedure by which an employee can protest the denial of benefits.<sup>85</sup> If an employee is not able to obtain satisfaction, he is given the right to sue the plan as an entity in the Federal courts.<sup>86</sup> The Secretary of Treasury and the Secretary of Labor may intervene in such action.<sup>87</sup>

## B. Coverage and Tax Equity

### 1. Prior Law

As stated above, in order to qualify for the special tax benefits, a plan ordinarily has to establish that the classification established for participation,<sup>88</sup> and the benefits or contributions,<sup>89</sup> do not discriminate in favor of employees who were officers, shareholders, supervisors or highly compensated. Under this test a reasonable classification would be acceptable, if it meets the so-called broad cross-section test.<sup>90</sup> The test appears to require that there not be an excessive disparity between the percentage of company employees within any low-earnings bracket and the percentage of employees in the plan in the same bracket.<sup>91</sup> Nevertheless, prior to ERISA, it was possible to establish a qualified plan that excluded part-timers, seasonal employees, hourly workers, employees who failed to contribute and those who earned below the Social Security limit. In combination, this could result in a fairly effective exclusion of low-income workers.

An alternative to non-discriminatory classification is a showing

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<sup>83</sup> INT. REV. CODE OF 1954, § 6057. Although this provision appears only in the Internal Revenue Code, it applies to all plans to which Title I applies, qualified or not. H.R. REP. NO. 1280, 93d Cong., 2d Sess. 385 (1974).

<sup>84</sup> ERISA § 1032 adding § 1131 to the Social Security Act. (42 U.S.C. § 1131).

<sup>85</sup> ERISA § 503, 29 U.S.C. § 1133 (Supp. IV, 1975). The Senate bill required all plans to establish an arbitration procedure. § 691 of H.R. 4200 as passed by the Senate on September 19, 1973.

<sup>86</sup> ERISA § 502, 29 U.S.C. § 1132 (Supp. IV, 1975).

<sup>87</sup> ERISA § 502(h), 29 U.S.C. § 1132(h) (Supp. IV, 1975).

<sup>88</sup> Prior to ERISA, INT. REV. CODE OF 1954, § 401(a)(3)(B) now INT. REV. CODE OF 1954, § 410(b)(1)(B).

<sup>89</sup> INT. REV. CODE OF 1954, § 401(a)(4). ERISA removed supervisory employees from the prohibited group unless they were also officers, shareholders or highly compensated.

<sup>90</sup> See SEN. COMM. ON FINANCE, PRIVATE PENSION PLAN REFORM, S. REP. NO. 383, 93d Cong., 1st Sess. 41-42, 44 (1973).

<sup>91</sup> Temp. Treas. Reg. § 11.410(b)-(1)(d)(2). Compare Rev. Rul. 70-200, 1970-1 CUM BULL. 101, with Rev. Rul. 74-255, 1974-1 CUM. BULL. 93 and Rev. Rul. 74-256, 1974-1 CUM. BULL. 94.

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that the plan covers more than 70 percent of the employees of the company.<sup>92</sup> Prior to ERISA, in determining whether a plan covered the required percentage, it was permissible to ignore those whose customary employment was not more than 20 hours per week or five months in any calendar year.<sup>93</sup> Such employees and probably even those who worked more regularly, but still less than full-time, were generally excluded from coverage without difficulty under the reasonable classification test.<sup>94</sup>

It was also common practice to limit a plan so that it did not extend to all divisions of a corporation.<sup>95</sup> Such a plan would certainly qualify if the covered divisions did not have a disproportionate number of higher paid employees, and it may even have been acceptable without examination of this issue. If the "divisions" were actually separately incorporated, it was fairly certain that a plan which covered all employees of one affiliate would automatically qualify.<sup>96</sup> Many corporations were able to have a richer plan for top management, if by accident or design such people were employed by a "management" corporation.

Under section 401(a)(5) of the Code, a plan is not considered discriminatory "merely because it is limited to salaried or clerical employees." This has been construed to mean that restricting plans to salaried employees is neither per se bad nor per se good.<sup>97</sup> It depends upon whether the salary levels of the covered employees is a fair cross-section of the corporation as a whole.

Another means to give lower paid employees relatively less benefits or entirely exclude them from a qualified plan is provided by integrating such plans with Social Security.<sup>98</sup> In general, this permits the employer to treat 50 percent of the Social Security benefit—the part financed by employer contributions—as part of his plan.<sup>99</sup> For example, the benefit formula may be 50 percent of pay reduced by 83 percent of the primary Social Security benefit.<sup>100</sup> Other plans provide a plan benefit only on average earnings on which the employee cannot expect a payment from Social Security.<sup>101</sup> For low income people this approach will mean little or no benefit from the private plan. For high income individuals the Social Security offset will have relatively little effect.

Finally, tax qualification will not be withheld from a plan which

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<sup>92</sup> INT. REV. CODE OF 1954, § 410(b)(1)(A).

<sup>93</sup> Former INT. REV. CODE OF 1954, § 401(a)(3)(A).

<sup>94</sup> *But see* Rev. Rul. 73-283, 1973-2 CUM. BULL. 133.

<sup>95</sup> *See* Treas. Reg. § 1.401-3(d) (1971).

<sup>96</sup> *See* HOUSE REP., *supra* note 76, at 49.

<sup>97</sup> *See Guides for Qualification of Pension, Profit-Sharing and Stock Bonus Plans*, IRS, PUB. NO. 788, pt. 4m, at 15 (Feb. 1972) [hereinafter cited as *Guides for Qualification*].

<sup>98</sup> INT. REV. CODE OF 1954, § 401(a)(5). Treas. Reg. § 1.401-3(e)(1971).

<sup>99</sup> Treas. Reg. § 1.401-3(c)(2)(i)(c)(1971).

<sup>100</sup> Rev. Rul. 71-446, 1971-2 CUM. BULL. 187 § 7 (Offset Plans).

<sup>101</sup> *See* Rev. Rul. 71-446, 1971-2 CUM. BULL. 187, §§ 3.02, 5.

denies coverage to employees who decline to contribute as long as the contribution level is not so high as to make it prohibitive for low income employees.<sup>102</sup>

## 2. Effect of ERISA

### (a) *Improvements in Coverage*

Part-time and seasonal employees must be included in the plan and given benefits for any year in which they work 1,000 hours.<sup>103</sup> Further, all employees of an affiliated group are considered employed by one employer.<sup>104</sup> The Committee Reports suggest that a plan for a separate division or subsidiary could not qualify unless the broad cross-section test is satisfied.<sup>105</sup> It seems arguable, however, that if the separate group is not an artificial segregation of management or other personnel, but represents a separate functional unit which can be split off without shifting of employees, the plan should be approved. In any event, under ERISA it will be impossible to segregate executives of an operating company into a separate corporation in order to provide a richer benefit, or to take advantage of such a segregation adopted for valid business purposes.

Moreover, while employers can still require employee contributions as a condition for participation and may even have been given some positive encouragement to continue such practice,<sup>106</sup> ERISA, on balance, has probably reduced the chances that an employee will be given a choice whether to participate or not. The main obstacle to the increase of contributory plans would seem to be the unfavorable tax treatment of employee contributions. Such contributions cannot be deducted even if required as a condition of employment, let alone a condition for benefits.<sup>107</sup> Employers tried to circumvent this difficulty by adopting so-called "salary-reduction plans" under which the employee could choose participation in the plan by accepting a decrease in salary. It was intended that the money provided by the salary decrease would still be considered an employer contribution. The Internal Revenue Service position on salary reduction plans was uncertain,<sup>108</sup> but

<sup>102</sup> Treas. Reg. § 1.401-3(d) (1971); *Guides for Qualification*, *supra* note 97, pt. 4g, at 13-14.

<sup>103</sup> INT. REV. CODE OF 1954, §§ 410(a)(3)(A), 411 (b)(3).

<sup>104</sup> INT. REV. CODE OF 1954, §§ 414(b), (c).

<sup>105</sup> HOUSE REP., *supra* note 76, at 49-50; SEN. REP., *supra* note 90, at 43-44.

<sup>106</sup> See text at notes 66 and 70 *supra*.

<sup>107</sup> See Treasury Explanation of H.R. 12272, reprinted in *Hearings on Tax Proposals Affecting Private Pension Plans Before the House Comm. on Ways & Means*, 92d Cong., 2d Sess., pt. 3, at 27, 31-32 (1972). Compare Rev. Rul. 72-250, 1972-1 CUM. BULL. 22.

<sup>108</sup> The Service for a limited period granted favorable rulings to such plans but on December 6, 1972 issued proposed regulations which would have considered contributions to salary reduction plans to be employee contributions. See statement of Frederic W. Hickman, then Ass't Sec'y of the Treasury for Tax Policy, from *Pension and Profit Sharing Plans: The Quintessential Tax Shelter* 16-17, before the 25th NAT'L CONF. OF

the Service has long permitted a choice between contributions to a plan and immediate receipt of a "bonus" without taxation of those who chose deferral. The only requirement was that one-half of the participants in the deferral plan be from the lower 2/3 of eligible employees.<sup>109</sup>

Under ERISA, at least until January 1, 1977, if a new arrangement is established which gives an employee a choice between current salary and a contribution to a qualified plan, the contribution is deemed to have been made by the employee and is currently taxable.<sup>110</sup> Since the employer has clearly indicated its willingness to make a cash payment, it is reasonable to consider the employee to have constructively received the salary and to have made the contribution himself. If made permanent, this rule would effectively preclude salary reduction plans except to the limited extent of contributions to Individual Retirement Accounts, as discussed in Section V of this article.

In instances where employees *do* make contributions to contributory plans, ERISA affords new protection.<sup>111</sup> Once an employee is 50 percent vested, employer contributions for his benefit cannot be forfeited merely because he chooses to withdraw his own contributions on separation from service or otherwise.<sup>112</sup> If the employee is less than 50 percent vested, forfeiture is permissible, but the plan must permit the employee to retrieve his benefit by repayment of his contributions.<sup>113</sup>

(b) *Noise But No Results*

ERISA has very little impact on the integration of plans with Social Security. It extended the administrative practice of precluding changes in the benefit due to improvements in Social Security following the beginning of the pay-out period,<sup>114</sup> to encompass *any* improvements following separation from service.<sup>115</sup> Thus, the plan benefit promised to the employee at the time of retirement or other

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THE TAX FOUNDATION (Dec. 5, 1973); 37 Fed. Reg. 24938 (1972).

<sup>109</sup> Rev. Rul. 56-497, 1956-2 CUM. BULL. 284.

<sup>110</sup> ERISA § 2006. This rule does not apply to employees of tax-exempt organizations and public schools. INT. REV. CODE OF 1954, § 403(b). There is no logical justification for this discrimination. See PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 61. It is perhaps not clear whether this provision applies to a one-time irrevocable choice to participate or not.

<sup>111</sup> Under defined benefit plans, employee contributions must be credited with interest. INT. REV. CODE OF 1954, § 411(c)(2)(C).

<sup>112</sup> INT. REV. CODE OF 1954, § 401(a)(19).

<sup>113</sup> *Id.* § 411(a)(3)(D)(i), (ii).

<sup>114</sup> Rev. Rul. 71-446, 1971-2 CUM. BULL. 187. See § 3.02 as to excess plans and § 7 as to offset plans.

<sup>115</sup> INT. REV. CODE OF 1954, § 401(a)(15); ERISA § 206(b), 29 U.S.C. § 1056(b) (Supp. IV, 1975).

termination of employment will remain fixed regardless of subsequent changes in Social Security.

The conference bill<sup>116</sup> originally provided that, until July 1, 1976 (approximately 2 years after the passage of ERISA), pension plans could not increase their level of integration with Social Security to take account of post-1971 Amendments to the Social Security Act. Although the conferees expressed concern and indicated they expected to study the matter in the period ahead, the conference restriction on integration was deleted by a concurrent resolution, after a vigorous telegram campaign.<sup>117</sup>

Finally, salaried-only plans may have become easier to establish. ERISA permits employees in a bargaining unit to be disregarded in determining whether a plan discriminates in favor of the higher paid.<sup>118</sup> It is claimed that unions often prefer other benefits to pensions and if this free choice is made, there is no reason, particularly when industry-wide bargaining is involved, to limit the pension of employees outside the bargaining unit to the level desired by the union.<sup>119</sup> If all hourly employees are unionized, ERISA removes all obstacles to a salaried plan.

### 3. Evaluation of ERISA

#### (a) Tax Qualification

As stated above, the only reasonable explanation of the special tax treatment for qualified plans is their use as a means of forced retirement savings for those who are not sufficiently motivated to provide for themselves. To maintain their current standard of living, lower paid individuals need at least as large a portion of pre-retirement income than the well-to-do, if not more.<sup>120</sup> On the other hand, employers appear to believe that high-paid employees wish a greater portion of their compensation to be deferred. If an equal proportion is contributed to a retirement plan for the lower-paid, the latter will not fully appreciate it and the entire cost could not be reflected in the wage level. Thus, many employers simply do what they

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<sup>116</sup> § 1022(g). See H.R. REP. NO. 1280, 93d Cong., 2d Sess. 131, 280-81 (1974). The Senate Bill extended the present integration rules applicable to plans covering self-employed individuals who are owner-employees. INT. REV. CODE OF 1954, § 401(d)(6), extending rules to corporate plan benefitting "proprietary-employees," i.e., 2% stockholders. See SENATE REP., *supra* note 90, at 126.

<sup>117</sup> 120 CONG. REC. S. 15737 (Aug. 22, 1974) (statement of Senator Williams).

<sup>118</sup> INT. REV. CODE OF 1954, § 410(b)(2)(A). There must be evidence that retirement benefits were a subject of good faith bargaining between the union and the employer.

<sup>119</sup> *Hearings on Tax Proposals Affecting Private Pension Plans Before the House Comm. on Ways & Means*, 92d Cong., 2d Sess., at 230 (1972). (statement of Mac Asbill, Jr. on behalf of the American Bar Ass'n); SENATE REP., *supra* note 90, at 42.

<sup>120</sup> Henle, *Recent Trends in Retirement Benefits Related to Earnings*, MONTHLY LABOR REV. 12, 18 (June, 1972).

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can to minimize participation by the lower paid in qualified plans.

The existence of contributory plans may be an indication that this practice exists. In light of the more favorable tax treatment of employer contributions, it is seemingly illogical for employers to insist on mandatory contributions rather than just offering lower salaries and paying the full cost of the pension. Excluding irrational behavior and assuming employees look at total compensation and not just nominal salary, the only reason for contributory plans would therefore be the desire to avoid contributions on behalf of those employees who place such a low value on pensions that they would be unwilling to accept an equivalent drop in salary. Contributory plans allow such people to self-select out of the plan.

Given the incentive for employer efforts to exclude low income employees, it seemed necessary to revise the tax laws to require greater participation and benefits for the lower paid than was previously necessary as a condition of qualification. In light of this goal, the amendments to the Internal Revenue Code concerning affiliated groups and part-time and seasonal employees were clearly justified. An employee working 1,000 hours would ordinarily be at his principal job. Encouraging pensions for such employees is certainly within the purposes of the tax law.<sup>121</sup> Allowing richer pensions for a group of employees merely because they were employed by a separate corporate entity was obviously unjustified.

On the other hand, ERISA's treatment of contributory plans is clearly inadequate. The assumptions made above would suggest that contributory plans cause a much greater loss of benefits for low income people. It is also difficult to find a justification for contributory plans. True, for a given dollar of employer contributions, the benefit will be higher if the employee contributes. Many employees may decline to do so, however, unless contributions are a condition of benefits. If the benefit would otherwise be inadequate, those employees who do contribute have been gently coerced into making sufficient provision for retirement. Still, it is not clear why the employer could not increase contributions and lower wages.

Admittedly, it would have been difficult without evidence in support of this hypothesis for ERISA to outlaw plans which deny coverage unless the employee voluntarily agrees to contribute. I would suggest, however, that Congress initiate a study to determine to what extent contributory plans lead to discrimination against low-paid individuals. It would be indeed unfortunate if one response to ERISA's requirements for coverage for many short-service or part-time employees might be to try to exclude such people by making the plan contributory.

In any event, it is certainly clear that once an employee contrib-

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<sup>121</sup> The desire to benefit a wider group of individuals could also explain the restrictions on maximum age as a condition for participation. INT. REV. CODE OF 1954, § 410(a)(2).



utes, he should not be offered the carrot of immediate recovery of his accumulated contributions upon pre-retirement separation from service, in order to secure his relinquishment of his right to the employer provided benefit. This practice, aside from being in direct conflict with the goal of promoting retirement savings, almost certainly leads to employees acting against their own interests without adequate information. Congress should eliminate this practice from the Civil Service Retirement System<sup>122</sup> and preclude forfeiture on withdrawal of employee contributions from private plans, even if there is less than 50 percent vesting.<sup>123</sup>

It is also my opinion that integration with Social Security as now practiced is inconsistent with the special tax benefits for qualified plans. As stated earlier, an incentive is offered to the higher paid (who presumably would provide for their retirement in any event) in order to encourage them to establish plans which also benefit the lower paid. This is necessary because Social Security alone is inadequate. It makes no sense to allow integration if it leads to complete exclusion of the low paid and limited benefits for the middle income group.

On the other hand, if Social Security could not be taken into account, it would be impossible for an employer to provide a pension adequate to replace pre-retirement earnings for the higher paid without giving the lower paid a combined annuity, from Social Security and the private plan, in excess of 100 percent of their income while employed. Thus, integration does have a proper role. The present rules, however, do not condition integration on a showing that the combined benefit would otherwise be excessive. It is only necessary to establish that the combined benefit does not discriminate against lower paid employees. Such a showing can be made even if some individuals receive only Social Security.

The Internal Revenue Service rules on integration assume that the total value of all Social Security benefits is approximately 162 percent of the primary insurance amount (PIA).<sup>124</sup> Since the employer is deemed to provide 50 percent of the benefit,<sup>125</sup> the employer would be given credit under its plan for 81 percent of the primary Social Security benefit. Thus, a plan formula providing a benefit of 40 percent of compensation reduced by 81 percent of the primary Social

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<sup>122</sup> 5 U.S.C. § 8342 (1970).

<sup>123</sup> This rule was recommended by the Labor Department in 1968, see *Hearing on S. 3421 Before the Subcomm. on Labor of the Comm. on Labor & Public Welfare*, 90th Cong., 2d Sess. 259 (1968) (Exhibit C to statement of Thomas R. Donahue, Ass't. Sec'y of Labor). See also *Panel Discussions on General Tax Reform Before the House Comm. on Ways & Means*, 93d Cong., 1st Sess. at 1089, 1090 (1973) (statement of Dan M. McGill).

<sup>124</sup> Treas. Reg. § 1.401-3(e)(2)(i)(b) (1971).

<sup>125</sup> *Id.* § 1.401-3(e)(2)(i)(c).

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Security benefit would be deemed to treat all workers alike.<sup>126</sup> This approach also allows a plan that excludes all earnings on which a Social Security benefit is earned as long as the plan benefit on the "excess"<sup>127</sup> earnings is not richer than the level of Social Security. For such an "excess" plan, the Social Security benefit provided by employer contributions is determined as a percentage of the wage base on which Social Security benefits are payable. Following the reasoning applied above, this should be 81 percent of the actual ratio of the PIA to the average monthly earnings (AME) on which it is based. At present, the Internal Revenue Service has set the integration level at 37½ percent.<sup>128</sup>

As described in Section VII, individuals retiring in 1976 can receive Social Security on, at most, only slightly in excess of \$7,000 of earnings. For those whose final earnings are at all significantly higher, Social Security cannot provide full replacement. In these circumstances, an integrated plan should not be permitted to exclude most of the earnings of a worker whose final earnings are \$8,000 or \$10,000 per year. Rather, the plan should be required to bring these retirees up to an adequate level before it can integrate. In other words, the plan benefit should not be allowed to take credit for social security unless the total benefit (social security<sup>129</sup> and private plan) on any

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<sup>126</sup> The Internal Revenue Service allows an 83 1/3% offset, Rev. Rul. 71-446, 1971-2 CUM. BULL. 187, § 7.01. This was probably allowed in order to maintain the offset percentage permitted in the previous ruling on integration. Rev. Rul. 69-4, 1969-1 CUM. BULL. 118, 121, § 7.01.

<sup>127</sup> The plan may provide a benefit only on wages in "excess" of earnings for which a social benefit will be payable. If the plan covers all wages the benefit on "excess" wages will be at a higher level.

<sup>128</sup> In 1971 when the last pronouncement on integration was issued, the average ratio of PIA to AME was not the 46.3% needed to justify resetting the integration level at 37½%. See Treas. Reg. § 1.401-3(e)(2)(i)(a) (1971). However, the Internal Revenue Service anticipated future improvements in benefits, Treas. Reg. § 1.401-3(e)(2)(i) (1971) in order to allow continued use of the 37½% figure which had been in effect since 1951. Mimeo. 6641, 1951-1 CUM. BULL. 41, 44. The 1951 calculation gave the employer credit for over 90% of the benefit. The Treasury Department kept the integration percentage constant, although the Social Security benefit was increasing, by crediting the employer with a decreasing portion of the total benefit. See Treasury Dep't Release F1403, 7 CCH 1968 STAND. FED. TAX REP. ¶6935C. In 1968 the Treasury determined that a 50-50 allocation was required and announced a new percentage of 30%. See Rev. Rul. 69-4, 1969-1 CUM. BULL. 118, 120, § 5.021. However, the effective date of the new rules for existing plans was such that 37½% was still in use when the 1971 regulations were issued. See *id.* at 124, § 19. This anticipation of future improvements has proved correct. The ratio of PIA to AME for employees retiring in 1976 is at least 62%. See Section VII, Part B, *infra*. If, in accordance with present practice, Treas. Reg. § 1.401-3(e)(2)(i)(a) (1971), this were averaged with the lowest possible ratio under current law (44%) the result (53%) would still justify an integration percentage of about 43%. Forty-four percent is the ratio of PIA to AME of \$1,175, the Social Security tax base during 1975. 40 Fed. Reg. 22291-96 (May 22, 1975). Of course, as discussed in Section VII B *infra*, the Social Security tax base is now open-ended and is in fact \$15,300 during 1976, or \$1275 per month.

<sup>129</sup> In this connection, it is difficult to decide whether the entire social security benefit or only the employer's share should be considered. While other private savings

level of earnings is at least 80 percent (if not 100 percent) of pre-retirement pay.<sup>130</sup>

I am uncertain of my reaction to the permission to disregard employees in a collective bargaining unit in determining whether a plan discriminates. I would like to know more than I do about the effect this rule will have on the collective bargaining process. In any event, this change removes the only justification for a plan limited to salaried employees; that is, one which excludes hourly workers. Such a plan may be in technical compliance with the cross-section test for qualification under the Code. However, while the cross-section test is fair, it should not be utilized to justify an unreasonable class. For example, I doubt if a classification of employees whose names begin with the letters A-M would be acceptable even if it passed the cross-section test. The salary-hourly classification does not have any greater justification. Accordingly, salaried plans should now be prohibited.<sup>131</sup>

(b) *Title I*

I have indicated approval of the tax amendments concerning affiliated groups, part-time and seasonal employees and limitation on forfeiture because of withdrawal of employee contributions. The support for the corresponding provisions of Title I of ERISA may be less clear.

Since Title I does not prohibit distinctions based upon job classifications or earnings levels, considering all employees of an affiliated group as employed by one employer<sup>132</sup> cannot require entry into the plan or accrual of benefits for employees of an affiliated company. It just means that years of service with an affiliate must be counted toward eligibility and vesting. Preventing the loss of accrued benefits for one who switches jobs within an affiliated group of corporations seems consistent with Title I.

An employee has mistakenly relied on retirement protection if he will in fact lose this protection through withdrawal of his own contributions. Although the employee is in a sense responsible for this failure of the pension system, it seems consistent with Title I to protect him against his folly.<sup>133</sup>

On the other hand, investigation might reveal that part-time and seasonal employees understood quite clearly that they were not entitled to retirement benefits. Therefore, it is not clear that required

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would obviously be ignored, the compulsory nature of the social security program may raise different considerations.

<sup>130</sup> See *Public Hearings on the Subject of General Tax Reform Before the House Comm. on Ways & Means*, 93d Cong., 1st Sess., pt. 12, at 5017, 5026 (1973) (statement of Victor Zonana).

<sup>131</sup> Compare PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PROGRAMS 60-61 (1965).

<sup>132</sup> ERISA § 210(c), 29 U.S.C. § 1060(c) (Supp. IV, 1975).

<sup>133</sup> See ERISA § 206(c), 29 U.S.C. § 1056(c) (Supp. IV, 1975).

coverage of such employees<sup>134</sup> or the restriction on a maximum eligibility age<sup>135</sup> can be explained. Congress seems simply to have decided to prescribe conditions for pension plans. While this is certainly appropriate when tax-relief is afforded, it is doubtful that, given a purely voluntary system, such provisions are an appropriate part of Title I. Perhaps, however, the part-time requirement is necessary to protect full time employees who at times work on a less than full time basis. The prohibition of a maximum age condition may derive from the policy of preventing age discrimination in employment.<sup>136</sup>

C. *Period of Distribution of Benefits*

I. *Prior Law*

The goal of a retirement program should be to provide income during retirement of the employee and perhaps his or her spouse. The pension should not be dissipated at an earlier stage, nor should the plan be utilized to accumulate an estate to be passed onto the next generation.

Thus, in 1962 when Congress extended the benefit of qualified plans to the self-employed, it required that distribution to substantial owners begin no earlier than age 59 1/2<sup>137</sup> and no later than age 70 1/2<sup>138</sup> even if the individual does not retire. Furthermore, distributions to all participants in plans in which the self-employed participate cannot extend beyond the period of life expectancy of the employee and spouse.<sup>139</sup>

Restrictions on qualified corporate plans are much more limited. Profit sharing plans can distribute benefits after a two-year accumulation<sup>140</sup> and while pension plans cannot ordinarily make pre-retirement distributions to employees,<sup>141</sup> distributions upon separation from service<sup>142</sup> or lump-sum distributions at retirement<sup>143</sup> are not

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<sup>134</sup> ERISA § 202(a)(3), 29 U.S.C. § 1052(a)(3) (Supp. IV, 1975).

<sup>135</sup> ERISA § 202(a)(2), 29 U.S.C. § 1052(a)(2) (Supp. IV, 1975).

<sup>136</sup> See 29 U.S.C. § 623(1970).

<sup>137</sup> INT. REV. CODE OF 1954, § 401(d)(4). The statutory term is "owner-employees" and it applies to sole-proprietors and partners with a 10% interest. INT. REV. CODE OF 1954, § 401(c)(3).

<sup>138</sup> INT. REV. CODE OF 1954, § 401(a)(9)(A).

<sup>139</sup> *Id.* § 401(a)(9).

<sup>140</sup> Rev. Rul. 71-295, 1971-2 CUM. BULL. 184. Many would argue that this permission is not inappropriate because profit-sharing plans are not necessarily intended to provide for retirement. Thus, some profit-sharing plans would not be subject to the eligibility and vesting requirements of Title I. See ERISA §§ 3(a)(2), 201, 29 U.S.C. §§ 1002(a)(2), 1051 (Supp. IV, 1975). I would agree but plans not intended to provide retirement income would need to present other arguments for the special tax benefit than those so far advanced.

<sup>141</sup> See Treas. Reg. § 1.401-1(b)(1)(i) (1972).

<sup>142</sup> *Guides for Qualification*, *supra* note 97, pt. 2(o)(1), at 9.

<sup>143</sup> *Id.* pt. 2(u), at 10. The lump sum distribution cannot be the only option, however.

prohibited. In fact, the latter are encouraged by favorable tax treatment.<sup>144</sup> It may also be possible to circumvent the restrictions on distributions during employment by the use of loans.<sup>145</sup>

Some employees, rather than obtaining their pension prior to retirement, seek to avoid any distribution at all or to spread the distribution over as long a period as possible. The regulations indicate that benefits payable to the beneficiary of an employee must be incidental to the primary purpose of distributing accumulated benefits to the employee.<sup>146</sup> The Internal Revenue Service has construed this to permit any settlement option, as long as the present value of the payments to be made to the participant is more than 50 percent of the present value of the total pension, or where the payment is made over the life of the employee and his spouse, even though the beneficiary who is to receive payment after the employee's death is not the spouse.<sup>147</sup> According to the Internal Revenue Service, this permits a 30-year pay-out. Further, since distribution need not start unless employment terminates, principal shareholders of close corporations are reluctant to "retire." In part, at least, the exclusion of the value of a qualified pension from the estate tax base<sup>148</sup> motivates this behavior.

Even if the employee arranges to receive a life annuity, retirement security is not assured for the employee's spouse if the employee dies first. Although many programs offered the employee a choice of providing a survivor annuity, the employee did not always take advantage of the opportunity.<sup>149</sup>

## 2. Effect of ERISA

It seems that the rules Congress adopted in 1962 for distributions to substantial owners of unincorporated businesses are valid and should be extended to all pension programs. ERISA unfortunately did not do so to any appreciable extent. It did, however, make it more likely that an employee will provide for his spouse.

### (a) *Pre-Retirement Distributions*

ERISA prohibits assignment or alienation of pension rights<sup>150</sup>

<sup>144</sup> See text at notes 154-63 *infra*.

<sup>145</sup> See *Guides for Qualification*, *supra* note 97, pt. 5(o), at 20.

<sup>146</sup> See Treas. Reg. § 1.401-1(b)(i), (ii) (1972).

<sup>147</sup> Rev. Rul. 72-240, 241, 1972-1 CUM. BULL. 108.

<sup>148</sup> INT. REV. CODE OF 1954, § 2039(c). The 1965 Report of the President's Comm. recommended the elimination of this exemption. PUBLIC POLICY AND PRIVATE PENSIONS PROGRAM, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 60.

<sup>149</sup> See PRIVATE PENSION TAX REFORM, H.R. REP. NO. 779, 93d Cong., 2d Sess. 65 [hereinafter cited as HOUSE REPORT]; *Hearings on Examination of Private Welfare and Pension Plans Before the Subcomm. on Labor of the Sen. Comm. on Labor & Pub. Welfare*, 92d Cong., 1st Sess. 8 (1971).

<sup>150</sup> ERISA § 206(d)(1), 29 U.S.C. § 1056(d)(1) (Supp IV, 1975); INT. REV. CODE OF 1954, § 401(a)(13).

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but does not preclude loans from a plan secured by the participant's nonforfeitable benefit.<sup>151</sup> The prohibition against forfeiture of a 50 percent vested benefit upon withdrawal of employee contributions<sup>152</sup> will probably result in the retention of retirement benefits that otherwise would have been lost. However, ERISA does not generally prohibit pre-retirement distributions. In fact they may be encouraged. Ordinarily, future service following a break-in-service can affect the nonforfeitable percentage of the benefit accrued prior to the break. However, if the nonforfeitable portion of the benefit is distributed at the time of termination from service, and either the amount distributed is less than \$1,750 or the distribution is with the employee's consent then, unless the employee repays the distribution, he will not obtain any greater interest in his pre-break benefit.<sup>153</sup>

### (b) *Lump-Sum Distributions*

For over 30 years the Internal Revenue Code has provided favorable tax treatment for so-called lump-sum distributions.<sup>154</sup> Prior to the Tax Reform Act of 1969, if the total value of the employee's account was distributed in one taxable year on account of death or separation from service, the amount received by the employee was treated as a long-term capital gain.<sup>155</sup> The 1969 Act denied capital gain treatment to the extent the distribution consisted of post-1969 employer contributions but the portion derived from earnings of the trust was to remain entitled to the favorable designation.<sup>156</sup> The allocation between the portion entitled to be treated as a long-term capital gain and the remainder of the distribution and the application of the special 7 year averaging procedure for the latter portion proved to be enormously complex.<sup>157</sup> Thus, Congress decided to try again.

In general after the transition period, a lump-sum distribution will be taxed as if it were distributed over a 10 year period and were the only income a single taxpayer earned during that time.<sup>158</sup> While I suspect the ERISA solution is an improvement over prior law,<sup>159</sup> it

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<sup>151</sup> ERISA § 206(d)(2), 29 U.S.C. § 1056(d)(2) (Supp. IV, 1975); INT. REV. CODE OF 1954, §§ 401(a)(13), 4975(d)(1).

<sup>152</sup> ERISA § 206(c) 29 U.S.C. § 1056(c) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 401(a)(19).

<sup>153</sup> See ERISA § 204(d), 29 U.S.C. § 1054(d) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(a)(7)(B), (C). HOUSE REPORT, *supra* note 149, at 58-59.

<sup>154</sup> See *Panel Discussions, supra* note 123, at 1069, 1073 (statement of Herman C. Biegel).

<sup>155</sup> INT. REV. CODE OF 1954, as it existed prior to the Tax Reform Act of 1969, § 402(a)(2).

<sup>156</sup> Tax Reform Act of 1969, Pub. L. No. 91-172, § 515(a)(1), adding § 402(a)(5) to the Internal Revenue Code. This section has been repealed by ERISA.

<sup>157</sup> HOUSE REPORT, *supra* note 149, at 37; *Panel Discussions, supra* note 123, at 1085-86. (statement of Herman C. Biegel).

<sup>158</sup> INT. REV. CODE OF 1954, § 402(e)(1)(C).

<sup>159</sup> *But see Written Statements on H.R. 10470 Before the House Comm. on Ways & Means*, 93d Cong., 1st Sess. 989, 991 (1973) (statement of Prof. Stuart Filler).

seems clear to me that the special treatment for lump sum distributions is a classic case of putting the cart before the horse. Ostensibly necessary to mitigate the harsh effect of a large distribution in one year, the special rule will often result in lump-sum distributions bearing less tax than benefits received in installments. In fact, many lump-sum distributions are the result of a desire to take advantage of the special tax treatment.

It is senseless to encourage retired persons to take the entire accumulation in one year instead of spreading the receipt of the pension over their lifetime.<sup>160</sup> There is indeed no reason for any distribution to be taxed all in one year. If an annuity contract is distributed, taxation is deferred until the annuity becomes payable.<sup>161</sup> ERISA permits a lump-sum distribution to be excluded from gross income if the amount of the distribution is transferred to an Individual Retirement Account.<sup>162</sup> Tax would be paid as the employee makes withdrawals from such account.<sup>163</sup> No special averaging procedure is necessary or desirable.

(c) *Provision for Surviving Spouse*

A retirement plan, as the name implies, is intended to provide for an employee after his working career ceases. If the employee dies prematurely, protection should be afforded from life insurance and not necessarily as part of a pension program. Thus, the employer may have a group insurance program and not pay death benefits through the retirement plan.

Confusion arises over the source of income for the support of the employee's dependents upon his death after retirement or close thereto. Group life insurance is ordinarily reduced for retired employees and the pension plan seems the more logical source. Therefore, employees who have dependents should elect to take their pension as a joint and survivor annuity, or in another form which would not end with their death. In some plans, a survivor annuity is the most commonly selected option,<sup>164</sup> but apparently in other cases, an employee's spouse was generally left unprotected after the employee's death.

ERISA seeks to remedy this problem by providing that if a plan pays benefits in the form of an annuity and an employee is married on the starting date of the annuity, then unless the employee elects otherwise the annuity must be paid for the life of the employee and

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<sup>160</sup> *Id.* PUBLIC POLICY & PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 65 (1965).

<sup>161</sup> INT. REV. CODE OF 1954, §§ 72, 402(a)(1); Treas. Reg. § 1.402(a)-1(a)(2) (1966).

<sup>162</sup> INT. REV. CODE OF 1954, § 402(a)(5).

<sup>163</sup> *Id.* § 408(d).

<sup>164</sup> TEACHERS INS. & ANNUITY ASS'N, COLLEGE RETIREMENT EQUITIES FUND, 1972-73 SURVEY OF RETIRED TIAA-CREF ANNUITANTS 83 (1974).

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his or her spouse.<sup>165</sup> Thus, in the absence of any affirmative action, the spouse will be protected. ERISA also requires the employer to allow the employee to elect a death benefit in the case of death before retirement, but after the early retirement date.<sup>166</sup> Although this provision makes it unnecessary to retire in order to protect one's spouse, the option need not be operative in the absence of the employee's election.

### III. SECURITY OF BENEFITS

A vested benefit is an empty promise if funds are not available to meet the plan's obligation. Thus, the tax advantages of qualified plans were available only if the plan were funded.<sup>167</sup> Further, assets were to be used exclusively for the benefit of the participants<sup>168</sup> and certain transactions between plans and related parties were scrutinized to make certain they met the requirements of arm's-length dealing.<sup>169</sup> These provisions serve to protect the employee against the financial failure of the employer.

ERISA increases this protection. The funding requirements for qualified plans, more stringent, specific and enforceable<sup>170</sup> than before, were made applicable to non-qualified plans.<sup>171</sup> Assets allocated to a pension plan, whether or not required by the funding standard must be held in trust.<sup>172</sup> If the employee's benefit is to vary with the performance of a particular fund managed by the employer, then such fund will presumably be deemed an asset of the plan for this purpose.

The responsibilities of a fiduciary were specified<sup>173</sup> and the federal courts were opened to litigation to make certain that a right would not be lost for want of a forum.<sup>174</sup> To avoid the necessity of determining whether dealing was at arm's-length, most transactions between employee benefit plans and related parties were

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<sup>165</sup> ERISA § 205, 29 U.S.C. § 1055 (Supp. IV, 1975); INT. REV. CODE OF 1954, § 401(a)(11).

<sup>166</sup> ERISA § 205(c), 29 U.S.C. § 1055(c) (Supp. IV, 1975) INT. REV. CODE OF 1954, § 401(a)(11)(C).

<sup>167</sup> *Guides for Qualification of Pension, Profit Sharing, and Stock Bonus Plans*, IRS, PUB. NO. 788, pt. 2(b), at 4 (Feb. 1972) [hereinafter cited as *Guides for Qualification*].

<sup>168</sup> INT. REV. CODE OF 1954, § 401(a)(2).

<sup>169</sup> *Id.* § 503, as it existed prior to ERISA.

<sup>170</sup> See Part B2 of this section, *infra*.

<sup>171</sup> ERISA § 301, 29 U.S.C. § 1081 (Supp. IV, 1975).

<sup>172</sup> ERISA § 403(a), 29 U.S.C. § 1103(a) (Supp. IV, 1975).

<sup>173</sup> ERISA §§ 402, 403, 404, 405, 409, 410, 29 U.S.C. §§ 1102, 1103, 1104, 1105, 1109, 1110 (Supp. IV, 1975). The last section prohibits exculpatory provisions.

<sup>174</sup> ERISA §§ 502(e),(f), 29 U.S.C. §§ 1132(e),(f) (Supp. IV, 1975). To eliminate the dilemma over whom to sue, the Act allows the plan to be sued as an entity. ERISA § 502 (d), 29 U.S.C. § 1132(d) (Supp. IV, 1975). For a discussion of the difficulties of enforcing one's rights under prior law, see COMM. ON LABOR & PUBLIC WELFARE, S. REP. No. 127, 93d Cong., 1st Sess. 227 (1973).



prohibited.<sup>175</sup> This included restrictions on investments in employer securities.<sup>176</sup>

In a plan of a defined contribution type where the employee's benefit depends upon the balance in his account, the above provisions, if effective, would be fully protective by assuring that the proper amount is set aside and not dissipated by defalcation or unwise investments.

In a defined benefit plan the problem is more difficult. Assets sufficient to provide the promised benefit may never have been contributed to the trust. Nevertheless, under ERISA, if a defined benefit plan terminates without adequate assets, payment of a basic level of benefits is guaranteed.

Part A of this section discusses the operation of defined benefit and defined contribution plans. Part B describes the causes of the shortage of assets on termination of defined benefit plans and the changes adopted to combat the problem. There has been no expressed concern about termination of defined contribution plans. Apparently, since specific benefits are not promised, there is nothing to guarantee.

Part C will try to determine if defined contribution plans really cannot have inadequate assets and to consider whether the divergence between defined contribution and defined benefit plans is justified. Finally, Part D of this section discusses whether the employee should be subject to the risk of fluctuation in the value of stock in the employer.

#### A. *Defined Benefit and Defined Contribution Plans*

Retirement programs can be classified into two principal categories: Defined Contribution<sup>177</sup> and Defined Benefit.<sup>178</sup>

Defined Contribution Plans are of two types—money-purchase and profit-sharing. Money-purchase plans call for specific contributions, usually a percentage of pay. Under profit-sharing plans, contributions are made out of corporate earnings, either at the discretion of the Board of Directors or under a formula stated in the plan. Stock-bonus plans are similar to profit-sharing except that contributions are not necessarily dependent upon profits and distributions must be made with employer stock. These contributions are credited to individual accounts for employees, the value of which fluctuates in

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<sup>175</sup> ERISA §§ 406, 408, 29 U.S.C. §§ 1106, 1108 (Supp. IV, 1975); INT. REV. CODE OF 1954, § 4975.

<sup>176</sup> ERISA § 407, 29 U.S.C. § 1107 (Supp. IV, 1975). See generally Herbert, *Investment Regulation and Conflicts of Interest in Employer-Managed Pension Plans*, 17 B.C. IND. & COM. L. REV. 127 (1976).

<sup>177</sup> ERISA § 3(34), 29 U.S.C. § 1002 (34) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 414(i). Title I also uses the term "individual account plan."

<sup>178</sup> ERISA § 3(35), 29 U.S.C. § 1002 (35) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 414(j).

accordance with the plan's investment income. Therefore, while the contributions to a money-purchase plan and, perhaps, profit-sharing plans as well, may be set with a specific benefit in mind, benefits are not guaranteed. The pension will vary depending upon the investment performance.

A defined benefit plan, as the name implies, provides for a specific benefit, frequently a percentage of compensation (for the years just prior to retirement) multiplied by years of service. Some plans, however, will average the employee's earnings over a longer period, occasionally his entire period of employment. Other plans, particularly those for a collective bargaining unit, provide a specified dollar benefit per year of service. The employer contribution to this type of plan is the amount necessary to pay the promised benefits, and will rise or fall with the investment performance.

### B. Termination of Defined Benefit Plans

#### 1. Shortage of Assets on Termination

An asset deficiency at termination arises because most defined benefit pension plans provide credit for service performed with the company prior to the establishment of the plan, or prior to the adoption of an amendment increasing benefits. Thus, at the time the plan is established, it will have liabilities (an unfunded initial liability) and no assets. In practice, most companies will fund this unfunded initial liability over 30 or 40 years, but since plans are continually amended, and this same 30 or 40 year period is used to fund the past service cost attributable to the amendment, the plan will almost never be fully funded. Further, prior to ERISA, Internal Revenue Service regulations did not require that the unfunded initial liability *ever* be funded: the minimum funding required was uncertain but there was no difficulty as long as the amount of unfunded liabilities was not allowed to grow any larger.<sup>179</sup> Some plans took advantage of this option.

If a plan continues in operation, this funding pattern is not likely to be serious. Contributions will exceed benefits paid out, creating an adequate reserve.<sup>180</sup> A crisis arises only if the plan terminates. At that point, it is usually true that plan assets will be substantially less than accrued benefits. If a significant portion of accrued benefits are vested, then plan assets may fall short of vested benefits as well.

Furthermore, the employer's promise to pay even vested benefits was, with rare exceptions, limited to the assets in the pension trust.

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<sup>179</sup> See Treas. Reg. § 1.401-6(c)(2) (1963).

<sup>180</sup> Panel Discussions on General Tax Reform before the House Comm. on Ways & Means, 93d Cong., 1st Sess., at 1069, 1077 (1973) (statement of Herman C. Biegel); See also *id.* at 1091 (Reprint of Study of Subcomm. on Labor, Sen. Comm. on Labor & Pub. Welfare).

Sometimes, the employer committed itself to a specified schedule of funding, but almost never did it promise to make good any deficiency in fund assets, even if the company were solvent.

There are three possible ways to allocate the burden of a shortage of funds on termination:

- (i) it can be placed on the beneficiaries of the terminated plan:
- (ii) it can be placed on the owners or stockholders of the employer—the employer could be required to make up the shortage out of its general assets; or
- (iii) it can be placed on business and employees generally through the installation of plan termination insurance.

Prior to ERISA, the burden was placed on the employee.<sup>181</sup> On its face this seems inexcusable. It is difficult for an employee to comprehend that he may not receive a vested pension even if the employer is solvent. It is obviously unusual for a promise to pay specified amounts to depend upon the total of fairly discretionary transfers from one pocket to another. Moreover, it could be worse if employees as a group understood the risk, and planned for retirement *without* regard to the possibility of a pension. Since most employees will receive the expected pension, this double saving is wasteful and inefficient.

ERISA places part of the burden on the employer through more rapid funding and a requirement that in certain circumstances it guarantee vested benefits up to a specific level. All employers with qualified plans must contribute to a guaranty fund<sup>182</sup> which will back up the terminating employer when it is unable—or, because of poor economic health, not required—to meet this obligation. The employee will bear the loss to the extent his vested benefits exceed the guaranteed level. The employee must also absorb the loss of non-vested benefits.<sup>183</sup>

## 2. Funding

One alternative method of guaranteeing sufficient assets on ter-

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<sup>181</sup> See SEN. COMM. ON FINANCE, PRIVATE PENSION PLAN REFORM, S. REP. NO. 383, 93d Cong., 1st Sess. 78-79 (1973).

<sup>182</sup> ERISA § 4006, 29 U.S.C. § 1306 (Supp. IV, 1975). A plan which in practice meets the requirements for qualification is subject to plan termination insurance even if it has not obtained a determination from the Internal Revenue Service. ERISA § 4021(a), 29 U.S.C. § 1321(a) (Supp. IV, 1975).

<sup>183</sup> This is probably a mistake given the long vesting periods sanctioned by ERISA, particularly in circumstances where the employer remains in business and the employee eventually attains the service required for vesting. See *Hearings on H.R. 1045, General Subcomm. on Labor, House Comm. on Educ. & Labor*, 91st Cong., 1st and 2d Sess. 102, 107 (1969-70) (statement by Andrew J. Biemiller on behalf of AFL-CIO).

mination would be to require immediate funding of all past service liabilities. Aside from being a serious deterrent to the establishment of plans or at least to the crediting of benefits for past service, most such funding would be unnecessary. As stated above, a crisis ordinarily arises only for those plans which terminate. It is not clear that it is advisable to require huge reserves to be built up under the control of trustees of private pension plans merely because a handful of such plans terminate.<sup>184</sup> Additional funding may be desirable only if necessary to protect the integrity of the guaranty fund.<sup>185</sup>

ERISA adopts a middle course which probably will not require much, if any, additional funding from the majority of employers. The initial past service cost, and any past service cost created by an amendment, must be funded over 30 years.<sup>186</sup> Failure to meet this standard is punished by an annual 5 percent tax on the funding deficiency.<sup>187</sup> Eventual compliance is assured by a threat of an excise tax equal to the amount of any shortage which remains uncorrected.<sup>188</sup> Thus, generally speaking, if a plan were not improved by amendment and actuarial estimates proved true, the plan would be fully funded 30 years after its creation.

### 3. Employer Guaranty—Plan Termination Insurance

Since full funding is delayed for 30 years, the employee would bear the risk of termination, unless the employer were liable or some sort of guaranty fund was established. The Nixon Administration, although recognizing that "even one worker whose retirement security is destroyed by the termination of a plan is one too many,"<sup>189</sup> nevertheless joined industry in opposing plan termination insurance and employer liability. It may be asserted that it is unfair to force the great majority of employers, who are able to fulfill their pension promise, to make contributions to an insurance fund to support those few employers who fail to meet their commitments.<sup>190</sup> Further, the opponents of insurance generally claimed that plan termination is not

<sup>184</sup> See *id.* at 701 (statement of Congressman Dent). *But see generally*, OLD AGE INCOME ASSURANCE PART V: FINANCIAL ASPECTS OF PENSION PLANS, SUBCOMM. ON FISCAL POLICY, JOINT ECONOMIC COMM., 90th Cong., 1st Sess. 36 (1967) (Paper by Roger F. Murray, *Economic Aspects of Pensions: A Summary Report*).

<sup>185</sup> See *Panel Discussions*, *supra* note 180, at 1126, 1137 (statement of Daniel Halperin).

<sup>186</sup> ERISA § 302(b)(2), 29 U.S.C. § 1082(b)(2) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 412(b)(2).

<sup>187</sup> *Id.* § 4971(a).

<sup>188</sup> *Id.* § 4971(b).

<sup>189</sup> Statement of Richard Nixon (Dec. 8, 1971) *reprinted in Hearings on Tax Proposals Affecting Private Pension Plans Before the House Comm. on Ways & Means*, 92d Cong., 2d Sess., pt. 1, at 6, 10 (1972).

<sup>190</sup> See *Panel Discussions*, *supra* note 180, at 1069, 1071 (statement of Herman C. Biegel).

an insurable risk,<sup>191</sup> because in many cases it is within the control of the employer who may stand to "profit" at the expense of the insurance fund. The essential difficulty is to guarantee benefits which in the absence of such guarantee would have gone unpaid, without undue expansion of the number of plan terminations. Terminations could, of course, be planned to take advantage of insurance, but this is not the only difficulty. A more serious risk is the possibility an employer, who would have struggled to keep a plan in operation in order to maintain a satisfied work staff, will terminate it once benefits are guaranteed. An early version of termination insurance sought to limit coverage to essentially involuntary terminations,<sup>192</sup> for example, closing of a facility or severe financial hardship, perhaps approaching insolvency. ERISA is not so restricted.

The Act<sup>193</sup> establishes the Pension Benefit Guaranty Corporation (PBGC) to insure pensions from qualified plans up to specified amounts in the event a plan terminates, for any reason, without sufficient funds to meet vested liabilities. The maximum insurable amount is a life annuity beginning at age 65, equal to the lesser of 100 percent of the employee's average compensation during the five consecutive calendar years for which his earnings were the highest, or \$9,000 annually adjusted by the percentage increase in the Social Security Wage Base since 1974.<sup>194</sup> The limit is now approximately \$10,430.<sup>195</sup> New plans or amendments increasing benefits will not be fully insured for 5 years.<sup>196</sup> There may, however, be partial coverage of these new benefits equal to the larger of 20 percent of the benefit or \$240 for each year since adoption, but only if the PBGC finds that the termination was for a "reasonable business purpose" and not part of a plan to obtain insurance.<sup>197</sup> An individual who is more than 10 percent owner of the business will obtain full insurance coverage only after 30 years of participation in the plan, treating each benefit increase provided by an amendment as if it were a new plan.<sup>198</sup>

If a plan termination occurs, the PBGC will assume responsibility for payment of insured benefits if the plan's assets are inadequate.<sup>199</sup> However, the employer is required to reimburse the PBGC for any

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<sup>191</sup> See, e.g., *Hearings, supra* note 189, at 578, 579 (Statement of Kenneth L. Houck); *id.* at 833, 837 (statement of the National Ass'n of Manufacturers). But see *Panel Discussions, supra* note 180, at 1089, 1101-06 (statement of Dan M. McGill).

<sup>192</sup> See *Hearing on S. 3421, Subcomm. on Labor, Sen. Comm. on Labor & Pub. Welfare, 90th Cong., 2d Sess.* 216, 235, 266 (statement of Thomas R. Donahue, Ass't Sec'y of Labor).

<sup>193</sup> ERISA §§ 4001-68, 29 U.S.C. §§ 1301-68 (Supp. IV, 1975).

<sup>194</sup> ERISA § 4022(a)(3), 29 U.S.C. § 1322(a)(3) (Supp. IV, 1975).

<sup>195</sup> The Social Security Wage Base is now \$15,300. In 1974 it was \$13,200. This requires an increase in the insured ceiling of approximately 15.9% or \$1,430 on \$9,000.

<sup>196</sup> ERISA § 4022(b)(1), 29 U.S.C. § 1322(b)(1) (Supp. IV, 1975).

<sup>197</sup> ERISA § 4022(b)(8), 29 U.S.C. § 1322(b)(8) (Supp. IV, 1975).

<sup>198</sup> ERISA § 4022(b)(6), 29 U.S.C. § 1322(b)(6) (Supp. IV, 1975).

<sup>199</sup> ERISA § 4061, 29 U.S.C. § 1361 (Supp. IV, 1975).

outlay up to 30 percent of the employer's net worth.<sup>200</sup> The PBGC is required to make insurance coverage for this potential liability available to employers<sup>201</sup> but it is authorized to prescribe conditions under which payment will not be made under such insurance.<sup>202</sup>

While no doubt it would have been better if the debate had been over "how to do it" instead of "whether it can or should be done," the foregoing scheme does reflect years of study and effort to design a guaranty program that is protective without being subject to excessive abuse.<sup>203</sup> Congress chose to provide insurance regardless of the reason for termination, thus taking the risk of "voluntary termination" off the employee and placing it on the guaranty fund. It hoped to protect the integrity of the fund by placing primary emphasis on employer liability.<sup>204</sup> If the employer must pay anyway, there is little to be gained by termination.

However, presumably to minimize the deterrent effect of employer liability on establishment of plans and the credit rating of employers,<sup>205</sup> the employer is only liable to the extent of 30 percent of its net worth and is to be offered insurance against this potential liability. Thus, if the insured unfunded liabilities substantially exceed 30 percent of net worth or the employer is insured against liability, the incentive to terminate remains. Protection against this occurrence is sought in the relatively low level of benefits protected (adequate for rank-and-file employees, but not large enough to provide a windfall to the higher paid decision-making officials), the 60-month phase-in of new benefits, and the stringent limits on benefits for substantial owners. It also appears that Congress did not intend to provide insurance coverage for employer liability, as long as the business continues, whether or not ownership has changed.<sup>206</sup> Only experience will tell whether ERISA has sufficiently protected the insurance fund against abuse.

### C. Insurance and Defined Contribution Plans

It is relatively certain, however, that the funding standard, the premium for plan termination insurance and the potential employer liability will cause some shift toward defined contribution plans. Therefore, it is necessary to consider whether termination insurance should have applied to at least some defined contribution plans.

Initially, it is necessary to decide whether defined contribution

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<sup>200</sup> ERISA § 4062(b), 29 U.S.C. § 1362(b) (Supp. IV, 1975).

<sup>201</sup> ERISA § 4023(a), 29 U.S.C. § 1323(a) (Supp. IV, 1975).

<sup>202</sup> ERISA § 4023(d), 29 U.S.C. § 1323(d) (Supp. IV, 1975).

<sup>203</sup> See Retirement Income Security for Employees Act of 1973, S. 4, S. REP. NO. 127, 93d Cong., 1st Sess. 204, 224 (1973).

<sup>204</sup> *Id.* at 224, SENATE REPORT, *supra* note 181, at 87; *Panel Discussions, supra* note 180, at 1089, 1093 (statement of Dan M. McGill).

<sup>205</sup> See SENATE REPORT, *supra* note 181, at 87.

<sup>206</sup> See *id.* at 89. ERISA § 4023(d), 29 U.S.C. § 1323(d) (Supp. IV, 1975).

plans in fact do not promise a specific benefit. Money-purchase plans have a fixed contribution which under ERISA must be made annually.<sup>207</sup> While profit-sharing plans do not have a definite contribution, in many circumstances the employer fully intends to contribute the maximum permissible amount. If the contribution is known, the expected pension can be estimated by making an assumption as to the period of service, the employee's salary and the earnings on the fund. The benefit is also subject to the employer's continued willingness and ability to make contributions.

While there is obviously a considerable amount of uncertainty, the departure from defined benefit plans turns out to be less than it seems. The "defined" benefit is also dependent upon the employee's future earnings and period of service, and, even after ERISA, on the employer's continuation of the plan. An employer can, in the absence of a collective bargaining agreement to the contrary, still terminate a defined benefit plan without any requirement that benefits continue to be accrued for service in the future, even for employees fully vested and close to retirement. If such a plan did not provide past service benefits, it would be fully funded on termination only if the investment performance and other actuarial assumptions, such as mortality and turnover, turned out as predicted. In a sense, then, the guaranty merely covers past service benefits and actuarial errors which have not been corrected at time of termination. Since each contribution under a defined contribution plan is ordinarily based upon current years earnings, defined contributions plans would be said not to provide past service benefits. Moreover, since contributions are credited to individual accounts, the only actuarial assumption which seems relevant to defined contribution plans is expected earnings. Therefore, unless there is to be a guarantee of investment performance, there is nothing to insure.

It may be, however, that this is an oversimplification. An employee can surely perceive a defined contribution plan as providing for past service. He would do so by taking his projected benefit and dividing it by all his years of service. Moreover, a defined contribution plan which is a Target Benefit Plan can do this explicitly. Such a plan computes the employee's benefit in the same manner as a defined benefit plan, for example, 1 percent per year of service including all years of past service.<sup>208</sup> The defined contribution is the level amount required to accumulate enough funds to pay this benefit, under a given interest rate. The benefit, however, is not guaranteed and it will be more or less than the "target" depending upon actual investment performance.

Assume an employee is age 45 with 10 years of past service at the time a Target Benefit Plan is adopted. If the target benefit is 1

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<sup>207</sup> H.R. REP. NO. 1280, 93d Cong., 2d Sess. 284 (1974). See ERISA § 301(a)(8), 29 U.S.C. § 1081(a)(8) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 412(h)(1).

<sup>208</sup> See Temp. Treas. Reg. § 11.410(a)-4(a).

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percent per year of service, the employee can expect a 30 percent benefit at age 65, assuming the plan's investment performance is as predicted. This employee may assume a 10 percent benefit has already been earned, but obviously if level contributions are to be made for 20 years, there will be sufficient assets only at age 65. After 1 year, for example, the employee's account balance will fall far short of what is required to provide an 11 percent benefit. It seems clear that many employees will be misled concerning the benefit they can expect. This suggests that such plans should be subject to the jurisdiction of the PBGC.

On the other hand, the message an employer gives when adopting a Target Benefit Plan could be stated in one of the following ways:

(i) "I am willing to provide you with a pension based upon all your service, past or future. However, I don't know how long I can keep the plan going, so I will only provide you with a percentage of your past service benefit for each year that the plan continues into the future," or

(ii) "Your total pension will be based upon all your years of service, past or future. However, once this amount is determined, it will be restated as a larger benefit for each future year."

In the latter case, for example, the 30 percent benefit in the foregoing example could be restated as a benefit of 1 1/2 percent for each of the 20 years of future service.

If this is a permissible message to employees under a defined contribution plan, is it reasonable to allow a defined benefit plan to operate in the same manner? In other words, can such a plan act as if there are no past service benefits? All benefits however computed would be "earned" pro rata for the future. ERISA does permit this for defined benefit plans, but only for plans funded by individual insurance contracts or their equivalent.<sup>209</sup>

If the current operation of target benefit plans and individual insurance contract plans is defensible, then it may be reasonable to provide similar protection for defined benefit plans. For example, if at the time it establishes or liberalizes a plan, the employer grants benefits for prior service, the employer's responsibility to pay for such benefits out of general corporate funds could be phased in slowly. ERISA does phase in this liability over a 5 year period,<sup>210</sup> but this may

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<sup>209</sup> ERISA § 301(b), 29 U.S.C. § 1081(b) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 412(i). The accrued benefit under these plans would be the cash surrender value of the insurance contract, assuming all premiums are paid when due. ERISA § 204(b)(1)(F), 29 U.S.C. § 1054(b)(1)(F) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(b)(1)(F). See also ERISA § 301(a)(2), 29 U.S.C. § 1081(a)(2) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 412(h)(2). If such premiums are paid, there would be no shortage to guarantee even though the cash surrender value would be inadequate to provide the per year benefit described in the plan formula.

<sup>210</sup> See text at note 197 *supra*.



be inadequate in light of the treatment of target benefit plans.

On balance, it seems logical to insist on a guarantee of the benefit, as long as past service is taken into account to increase the future benefit and thereby the required contribution. This approach is more likely to conform to the employee's understanding. If so, then the treatment of target benefit plans and individual insurance contract plans needs further explanation.

#### D. *Employer Securities*

If a defined contribution plan invests in employer securities, the employee bears the risk of fluctuation in value. He thus stands to share in the good or bad fortune of the company.

If employer securities held by a defined benefit plan decline in value, the initial impact is to increase the employer's contributions to the trust. The employee will suffer directly only if the plan terminates and, if the plan is qualified, only to the extent his benefits are not vested or are in excess of the guarantee limit. Indirectly, however, the fund's investment performance probably influences the level of benefits the plan will provide.

This section considers whether an investment in stock of the employer is consistent with congressional insistence that retirement plans be funded and prudently invested. It seems clear that it is not. Stock ownership in the employer is even less protection to the employee than the creditor status of an unfunded plan, because the employee as stockholder is subordinated to all creditors. If the company fails, the employee not only loses his job, but also, except for plan termination insurance, his nest egg for retirement. Moreover, in many cases the employee is not expected to retain permanent ownership of the stock. The stock will be redeemed at retirement in order to provide cash to meet living expenses. In such situations, the employee is dependent upon the employer's ability to redeem the stock at the time of his retirement. This seems equivalent to the risk the employee assumes under an unfunded deferred compensation arrangement in which the amount he will receive depends upon the value of the employer stock at time of distribution. In fact, it is a greater risk. Under a non-qualified plan, the employer gets a tax deduction at the time of distribution which will help generate funds for the payment. Contributions to a qualified plan, even in the form of employer's stock, are deductible when made. This deduction provides a cash saving to the employer at that time, but unless this amount is specifically set aside for the purpose of redeeming the stock, the employer will need to generate cash at the time of distribution without benefit of the tax deduction.

For example, if the employer contributes \$1,000 of its own stock to a qualified plan, it would provide an immediate tax saving of \$500. Assuming no change in value, the employer would require \$1,000 to redeem the stock at the time of the employee's retirement. If it de-

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sires to finance this obligation currently, the employer could set \$1,000 aside and invest it in a manner it would hope would mirror the performance of the employer stock. The result would be a net cash outlay of \$500, the same cost as a cash contribution of \$1000.

However, the corporation would almost certainly choose to meet the redemption obligation out of future earnings and thus avoid the immediate set aside. Since the redemption, when it occurs, will be a non-deductible expenditure, the employer will need cash equal to the full value of the stock, \$1000 if there is no change in value. In comparison, a distribution of an equal deductible amount under an unfunded plan would require only \$500.

Prior to ERISA, it was unclear to what extent a qualified plan could be invested in employer securities. Stock bonus plans were required to make distributions in such securities.<sup>211</sup> Moreover, the Internal Revenue Code provided favorable tax treatment for distributions of employer securities from all types of qualified plans.<sup>212</sup> Therefore, such investments were obviously not precluded. On the other hand, as stated above, assets were to be used for the exclusive benefit of participants and transactions between the plan and related parties had to be at arm's-length.<sup>213</sup> These provisions were peculiarly applicable to investments in employer securities.<sup>214</sup>

ERISA places an overall limit on acquisitions of employer securities by all funded pension plans in that immediately after the acquisition, the total holdings of employer securities cannot exceed 10 percent of the fair market value of the assets of the plan.<sup>215</sup> However, this restriction does not apply to "an eligible individual account plan,"<sup>216</sup> which includes any profit sharing or stock bonus plan.<sup>217</sup> Such a plan can invest all of its assets in employer securities and is specifically exempt with respect to such holdings, from the general diversification requirement<sup>218</sup> and even the prudent investment rule<sup>219</sup> to the extent it requires diversification.<sup>220</sup> The requirement of prudence, aside from diversification, applies to an undetermined extent.

Unless employee ownership of the business has strong public policy objectives which override the interest in retirement security,<sup>221</sup>

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<sup>211</sup> Treas. Reg. § 1.401-1(b)(1)(iii) (1972).

<sup>212</sup> INT. REV. CODE OF 1954, § 402(a)(1). The applicable rules for lump sum distributions were previously contained in § 402(a)(2). Now it is also necessary to consider § 402(e)(4)(J).

<sup>213</sup> INT. REV. CODE OF 1954, § 401(a)(2); *id.* § 503 as it existed prior to ERISA.

<sup>214</sup> See Treas. Reg. § 1.401-1(b)(5)(ii); *Guides for Qualification*, *supra* note 167, at pt. 2(k), at 7 (Feb. 1972).

<sup>215</sup> ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2) (Supp. IV, 1975).

<sup>216</sup> ERISA § 407(b)(1), 29 U.S.C. § 1107(b)(1) (Supp. IV, 1975).

<sup>217</sup> ERISA § 407(d)(3)(A), 29 U.S.C. § 1107(d)(3)(A) (Supp. IV, 1975).

<sup>218</sup> ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (Supp. IV, 1975).

<sup>219</sup> ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (Supp. IV, 1975).

<sup>220</sup> ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2) (Supp. IV, 1975).

<sup>221</sup> So-called Employee Stock Ownership Plans (ESOPs) have been championed as a means of solving current economic difficulties. For example, § 46(a)(1)(B) of the In-

it is clear these exceptions are not warranted. At least the 10 percent limit should be applied across the board. Moreover, distributions in employer securities should be taxed to the same extent as other property.<sup>222</sup> In any event, the special tax benefits of qualified plans should not be available to the extent the plan's assets consist of employer stock.

#### IV. ESTABLISHMENT OF PLANS

Sections II and III of this Article strongly suggest that under ERISA, despite its shortcomings, if the employer has a plan, the employee is more likely to be a participant and to actually obtain a benefit. The next question to be addressed is the impact of the Act on the number and types of plans that can be expected to exist.

Wherever ERISA eases restrictions, it will tend to encourage the establishment of pension plans. For example, since partners and sole proprietors can now contribute more for themselves, they are more likely to establish plans for their employees.<sup>223</sup> Plans for the non-unionized portion of the work force may increase since it is now easier to exclude employees in a collective bargaining unit.<sup>224</sup>

For the most part, however, ERISA reduces employer freedom. Since this makes it less likely that an employer will be able to achieve its goal, it is obvious that ERISA will have an inhibiting effect on the maintenance of plans.<sup>225</sup> This is not necessarily inconsistent with the intent of the legislation. Fewer plans are acceptable because the ones that remain will cover more people, will provide benefits consistent with public policy and will live up to their promise.

ternal Revenue Code of 1954 as added by § 301(a) of the Tax Reduction Act of 1975, Pub. L. No. 94-12 provides an extra 1% investment credit if the employer transfers stock of an equivalent value to an employee stock ownership plan meeting the conditions of § 301(d) of the Act. See Tax Reduction Act of 1975, S. REP. NO. 36, 94th Cong., 1st Sess. as reprinted in 1975-1 CUM. BULL. 590, 617; *Hearings, supra* note 189, at 647 (testimony of Louis O. Kelso); Chadwick & Foster, *Federal Regulation of Retirement Plans: The Quest for Parity*, 28 VAND. L. REV. 641, 686-87 (1975). Not everyone would agree with ESOPs' supporters. See generally *Hearings on Stock Ownership Plans, Joint Economic Comm.*, 94th Cong., 1st Sess. (Dec. 11, 12, 1975); *Free Distributions of Stock to Employees are Spurred by New Tax-Law Provision*, Wall St. J., April 29, 1975, at 44, col. 1.

<sup>222</sup> PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 66 (1975).

<sup>223</sup> The contribution limit for self-employed individuals was raised from \$2,500 (or 10% of earned income if less) to \$7,500 (but no more than 15% of earned income). INT. REV. CODE OF 1954, § 404(e)(1).

<sup>224</sup> See text at notes 118-19 *supra*.

<sup>225</sup> There has been widespread publicity concerning "5000 plan terminations," more than had been predicted, which critics have pointed to as showing the failure of ERISA. A PBGC study apparently indicates that the economy, rather than ERISA, is the chief culprit. See N.Y. Times, March 21, 1976, at 25, col. 1; PRENTICE HALL, PENSION & PROFIT SHARING REP. NO. 13, at ¶13.3 (March 5, 1976). The latter also reports a floor statement by Sen. Javits referring to a study by the Institutional Investor which indicates that almost 80% of the corporations surveyed had less than a 5% cost increase from ERISA. 122 CONG. REC. S. 2498 (Feb. 26, 1976).

Many of the missing plans would have been designed to provide nearly all their benefits to a few high paid employees. Others would have turned out to be an illusion, leaving employees without provision for retirement. The loss of such plans is a positive not a negative result. On the other hand, employees who actually would have benefited if the terminated subpar plan was allowed to continue, and who turn out to be unable to provide for themselves, will be worse off as a result of ERISA.

In summary, the Act's approach to promoting retirement security involves a delicate balancing act<sup>226</sup> which cannot be evaluated without empirical evidence. At this point, however, there are two more specific effects of ERISA on the type of retirement programs which are obvious enough to warrant further discussion.

ERISA makes it practically impossible to maintain non-qualified plans for rank-and-file employees. Part A of this Section considers whether this is a desirable result.

As noted above, the combined effect of funding, plan termination insurance and employer liability on defined benefit plans suggest to some that defined contribution plans, if not the only feasible alternative, are at least a more likely choice than before. The implications of this possible course of action are discussed in Part B.

#### A. ERISA and Non-Qualified Plans

Prior to ERISA, employers established non-qualified retirement plans to meet two distinct objectives. Some plans were established for key executives to provide extra benefits that employers did not want to provide on a non-discriminatory basis to a large group of employees. In other circumstances, non-qualified plans were maintained for rank-and-file employees because the employer wanted to avoid the commitment that a qualified plan implied; that is, the employer wanted total discretion as to who was to participate, the amount of benefits and when funds were to be set aside. Some of these arrangements operated, at least ostensibly, on a purely ad-hoc basis.

##### 1. Non-Qualified Plans and Title I

Since the vesting and funding requirements of ERISA do not apply to an unfunded plan "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees"<sup>227</sup> the Act generally has little impact on the continuation of non-qualified plans of the first type.<sup>228</sup> High paid employees were considered to be able to fend for themselves and not

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<sup>226</sup> See Comment, *The Employee Retirement Income Security Act of 1974: Policies and Problems*, 26 SYR. L. REV. 539, 555 (1975).

<sup>227</sup> ERISA §§ 201(a)(2), 301(a)(3), 29 U.S.C. §§ 1051(a)(2), 1081(a)(3) (Supp. IV, 1975).

<sup>228</sup> See Section VI, Part C *infra*.

in need of the protection afforded by ERISA.

The implication of ERISA for plans for the rank-and-file depends upon whether it is a "plan, fund, or program which . . . by its express terms or as a result of surrounding circumstances . . . provides retirement income to employees."<sup>229</sup> An argument could be made that an arrangement which does not promise or guarantee benefits to the employees does not constitute a "plan, fund, or program" for purposes of ERISA. Such an argument might find support in section 2 of ERISA, which in setting forth the congressional findings leading to its enactment, emphasizes the problem of employees losing "anticipated" benefits. Arguably, the protection afforded by ERISA is inappropriate to programs designed to assure that employees do not anticipate benefits.

On balance, however, this argument is unpersuasive. The Labor Department has excluded "gratuitous payments" from ERISA coverage in the case of employees who both retired and started receiving such payments out of their employer's general assets before September 2, 1974, providing the employer annually notifies such employees that all such payments are gratuitous.<sup>230</sup> One can infer from this regulation that other "gratuitous payment" retirement programs are, in the view of the Labor Department, subject to all pertinent ERISA requirements. This is consistent with the view expressed earlier that employers should not be allowed to promise a pension unless there is a fairly good assurance the promise will be kept.<sup>231</sup>

In the first place, it is difficult to believe that word of retirement payments does not spread to the continuing work force. Once employees know of such payments, they are likely to "anticipate" them. Moreover, dangling a pension before an employee, at least during the period he can expect to save for retirement, has an undesirable impact regardless of the employee's appreciation of the uncertainty. The loss if he expects a pension and does not get it is obvious. On the other hand, if he saves as if a pension will not be forthcoming, and he turns out to have been too pessimistic, there is undesirable and inefficient double saving. Thus, the application of the participation and vesting requirements of Title I to non-qualified plans is reasonable.

As noted above,<sup>232</sup> non-qualified plans *are* subject to the funding standards and any assets of such plan would be required to be held in trust. There is no specific penalty for failure to meet the funding or

<sup>229</sup> ERISA § 3(2)(A), 29 U.S.C. § 1002(2)(A) (Supp. IV, 1975).

<sup>230</sup> 29 C.F.R. § 2510.3-2(e), 40 Fed. Reg. 34532 (Aug. 15, 1975). Compare 40 Fed. Reg. 24642 (June 9, 1975). ("These terms [plan or program] contemplate a systematic and predetermined treatment of classes or types of similar situations. An informal policy . . . fails to rise to the level of a plan or program.") The Labor Department has announced its intention to extend the cut-off date to employees retiring before the end of 1976. Dep't of Labor News Release 76-707, P-H Pension & Profit Sharing ¶135160 (Apr. 26, 1976).

<sup>231</sup> See text at note 18 *supra*.

<sup>232</sup> See text at notes 171-72 *supra*.

trust requirement.<sup>233</sup> The Labor Department can bring suit to compel compliance,<sup>234</sup> but may be unlikely to do so unless the employees complain. The employees may be unwilling to insist upon funding, if such funding means current taxation. Nevertheless, this seems a risky scenario for the employer to rely on, particularly since company officials responsible for the failure to fund would seem to be in danger of being personally liable for any benefits lost by such failure.<sup>235</sup> Thus, it seems likely that funding, or its equivalent, will be required in nearly all cases. Again, this seems justified by the considerations set forth in Section III of this paper. However, while it would have been logical to extend the protection of plan termination insurance to such plans, ERISA does not do so unless the plan qualifies in fact.<sup>236</sup>

## 2. Tax Treatment of Non-Qualified Plans

Title I of ERISA in general does not impose any restrictions on the class of employees covered by non-qualified plans. Thus, a plan limited to high paid individuals can continue to exist. This seems justified as long as pension coverage is not mandatory and the plan in question does not seek any special tax relief. However, once the coverage of a plan is sufficiently widespread so as to lose the benefit of the exemption of plans "primarily for a select group of management or highly paid employees," the lack of restrictions on coverage will have little practical value. Since vesting and funding are mandatory, it will be virtually impossible to avoid funding vested benefits for particular employees. The value of such benefits is taxed to the employee, even though distribution is delayed.<sup>237</sup>

If it is assumed that employees will not accept taxation without distribution, an unqualified plan becomes impractical, and any plan for the rank-and-file must be qualified. If qualification is also unacceptable, termination may be the only recourse. It is questionable whether it was necessary to create this dilemma.

There is no essential connection between ERISA's policy which calls for funding and vesting and the tax policy which suggests that vested funded benefits be taxed. The most significant advantage of a qualified plan is the ability of the employer to deduct compensation without it being taxed to the employee.<sup>238</sup> Certainly, this cannot be allowed under a non-qualified plan. However, it is not clear that it would be unacceptable to delay taxation if the employer was also re-

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<sup>233</sup> INT. REV. CODE OF 1954, § 4971, is applicable only to qualified plans.

<sup>234</sup> ERISA § 502(a)(5)(B)(ii), 29 U.S.C. § 1132(a)(5)(B)(ii) (Supp. IV, 1975).

<sup>235</sup> See ERISA § 409, 29 U.S.C. § 1109 (Supp. IV, 1975).

<sup>236</sup> Under ERISA § 4021(a), 29 U.S.C. § 1321 (Supp. IV, 1975), plan termination insurance applies only to plans which have received a favorable determination from the Internal Revenue Service or which in practice have met the requirements of the Internal Revenue Code.

<sup>237</sup> INT. REV. CODE OF 1954, §§ 83, 402(b).

<sup>238</sup> See text at notes 14-15 *supra*.

quired to defer its deduction. In other words, could vested benefits of a non-qualified plan be treated like non-vested benefits for tax purposes?

Under the Internal Revenue Code, if a trust is created under a non-qualified plan, the trust is taxable on its income<sup>239</sup> and employer contributions are not deductible until the employee's interest vests.<sup>240</sup> In computing its taxable income, the trust will be entitled to a deduction for distributions to the employee but only to the extent of earnings on the distributee's share of the fund.<sup>241</sup> Distributions to the employee will be taxed under the rules relating to annuity contracts,<sup>242</sup> not the provisions applicable to trust distributions.

The application of these rules may be explained by the following example. On January 1, 1974 the employer contributes \$10,000 to a non-qualified trust on behalf of Smith. Smith must work until December 31, 1978, his normal retirement date, in order to obtain a non-forfeitable benefit. The trust buys bonds, which produce annual interest of 10 percent per year, and it is subject to tax at an effective rate of 20 percent. On December 31, 1978 the trust distributes \$14,966 to Smith, determined as follows:

*Example 1—Deferral*

	<i>Value of Account</i>	<i>Interest</i>	<i>Tax</i>	<i>Year End Value</i>
Jan. 1, 1974	\$10,000	\$1,000	\$200	\$10,800
Jan. 1, 1975	10,800	1,080	216	11,664
Jan. 1, 1976	11,664	1,166	233	12,597
Jan. 1, 1977	12,597	1,260	252	13,605
Jan. 1, 1978	13,605	1,361	— <sup>243</sup>	14,966

If Smith's tax rate at retirement were 20 percent, the distribution of \$14,966 will provide him with \$11,973 after tax. Two thousand dollars of Smith's tax payment of \$2,993 is applicable to the original \$10,000 and the remaining \$993 to the trust income. The corporation's deduction of \$10,000<sup>244</sup> in 1978 will, assuming an effective rate of 50 percent, reduce its taxes by \$5,000.

In order to appreciate the potential benefit to Smith from this deferral, we will determine the total accumulated if Smith received \$10,000 currently and invested the after-tax amount in the same

<sup>239</sup> See Rev. Rul. 74-299, 1974-1 CUM. BULL. 154.

<sup>240</sup> INT. REV. CODE OF 1954, §§ 83(a), 402(b), 404(a)(5).

<sup>241</sup> See Rev. Rul. 74-299, 1974-1 CUM. BULL. 154.

<sup>242</sup> *Id.*; INT. REV. CODE OF 1954, § 402(b).

<sup>243</sup> The trust is entitled to a deduction for the distribution, and thus it has no taxable income. INT. REV. CODE OF 1954, § 661(a).

<sup>244</sup> The corporation's deduction is not the amount received by Smith but its original contribution to the trust when "an amount attributable to such contribution is includible as compensation." See Proposed Treas. Reg. § 1.404(a)-12(b)(1) (1971).

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bonds. In this case, it will be assumed that Smith would have been taxed at a 30 percent rate on both compensation and investment income had he received current salary. Furthermore, it is assumed that the corporation's position will be unchanged, that is, it will spend \$10,000 on January 1, 1974 and will retain the benefit of a \$10,000 deduction on December 31, 1978. Therefore, we must consider the corporation's disposition of the earnings provided by the \$5000 tax savings from the deduction in 1974.<sup>245</sup>

*Example 2—Current Salary*

<i>Smith</i>	<i>Value of Investment</i>	<i>Interest</i>	<i>Tax</i>	<i>Year End Value</i>
Jan. 1, 1974	\$7,000	\$700	\$210	\$7,490
Jan. 1, 1975	7,490	749	224	8,015
Jan. 1, 1976	8,015	802	241	8,576
Jan. 1, 1977	8,576	858	257	9,177
Jan. 1, 1978	9,177	918	275	9,820

  

<i>Corporation</i>	<i>Value of Investment</i>	<i>Interest</i>	<i>Tax</i>	<i>Year End Value</i>
Jan. 1, 1974	\$5,000	\$500	\$250	\$5,250
Jan. 1, 1975	5,250	525	263	5,512
Jan. 1, 1976	5,512	551	275	5,788
Jan. 1, 1977	5,788	579	290	6,077
Jan. 1, 1978	6,077	608	304	6,381

At this point the corporation has \$6,381, or \$1,381 more than the \$5,000 it wishes to retain. The corporation can transfer the extra \$1,381 to Smith if it makes a deductible salary payment of \$2,763. At the 20 percent rate assumed applicable at retirement, Smith will obtain an additional \$2,210 after payment of tax of \$553. Thus, the total received by Smith is as follows:

Example 1:	\$11,973	Example 2:	\$9,820
			2,210
			\$12,030

The comparison is highly sensitive to the assumptions of Smith's current tax rate, the change in his rate at retirement, the period of deferral, the rate of interest and the tax paid by the trust on its investment income. The source of the \$57 detriment from deferral in the foregoing example can be seen from the following table explaining the growth of the original \$10,000.

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<sup>245</sup> The possible advantage of investing in corporate stock is not considered. See Section VI, Part C *infra*.



	<i>Deferred Compensation</i>	<i>Current Compensation</i>	<i>Difference</i>
Tax on \$10,000 Compensation	-2,000	-3,000	+1,000
Interest for 5 years	+5,867	+6,790	- 923
Tax on Interest—			
Trust	- 901	-1,760 <sup>246</sup>	- 134
Smith	- 993		
	<u>\$1,973</u>	<u>\$2,030</u>	<u>- \$57</u>

The employee's tax savings from the lower marginal tax rate after retirement (\$1,000) is offset by a decline in investment income. This decline will occur if the corporation's tax rate is higher than the employee's since in such cases, the delay of the corporate deduction increases the overall tax burden and, thus, reduces the amount left to invest. Further, the double tax on investment income at the trust and employee level offsets the reduction in the employee's marginal rate. If there was a greater reduction in Smith's marginal rate, then the foregoing example would have resulted in an advantage from deferral. However, such advantage may be said to result from lifetime averaging. Such averaging for rank-and-file employees may only represent the extension of an advantage already widely used by the highly paid.<sup>247</sup> Thus, the equitable distribution of the tax burden might not require the present treatment of non-qualified plans. Nevertheless, the inability to maintain such plans has positive results to the extent there is a conversion into more equitable qualified arrangements. On the other hand, if such plans are discontinued, there is a net loss in retirement security since the assumption here is that the employer was willing to conform to the vesting and funding requirements. This is a matter for investigation but it seems reasonable to consider the possibility of an amendment to the Internal Revenue Code.

#### B. *Defined Benefit Plans After ERISA*

It has been argued that defined contribution plans should be preferred to those of the defined benefit type.<sup>248</sup> Contributions under money-purchase plans tend to be a level percentage of pay regardless of age. If it is assumed a steady increase in salary will take place and that an adequate retirement income must be measured against earnings at the time of retirement, the contribution level will have to be higher than it would be if earnings were expected to remain steady. Thus, the vested benefit under a money-purchase plan will include some

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<sup>246</sup> Smith paid tax of \$7,207 on his investment income plus an additional \$553 when the corporation transferred its investment income to him.

<sup>247</sup> See Section VI, Part C *infra*.

<sup>248</sup> TIAA-CREF, *The Participant*, July 1973, at 4-5.

provision for anticipated increases in earnings. A defined benefit plan on the contrary will determine the value of a vested benefit by reference to earnings at the time of separation from service. Under the latter, therefore, the amount of pension will be less if the employee changes jobs than if he stays with one employer.<sup>249</sup> A money-purchase plan will produce the same benefit in both situations. On the other hand, this analysis assumes the employer correctly perceives the rate of salary growth and it ignores the difficulty of providing for past service under a money-purchase plan started or improved when the employee is in mid-career.

On balance, I believe a defined benefit plan is preferable. The principal argument for Social Security and other forced savings for retirement is the difficulty faced by an individual in attempting to plan on his own. As noted above, people do not ordinarily face the issue far enough in advance, and when they do, they find it hard to determine how much to put aside. A defined contribution plan is not a full solution. The amount available at retirement is a function of earnings on the fund. Further, the adequacy of the accumulation to enable maintenance of the pre-retirement living standard depends upon the change in salary level over one's career. Very few individuals can estimate the adequacy of their benefit from a defined contribution plan. A defined benefit plan, if it promises a specified percentage of earnings at retirement (or of average earnings over the last five years), provides much greater security. At least the employee will know what the benefit will be, and can determine if he desires additional saving.

There is an obvious dilemma here. Plan termination insurance seems a necessary part of a defined benefit plan but it can do more harm than good if it causes a significant shift to defined contribution plans. This might not be a serious worry if employees come to understand the advantages and have the economic power to force retention of defined benefit plans and the security of plan termination insurance.<sup>250</sup> Moreover, defined contribution plans, even those of the money-purchase type, are not complete substitutes for defined benefit plans.<sup>251</sup> Nevertheless, it seems worthwhile to consider the issue raised

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<sup>249</sup> See text at notes 38-39 *supra*.

<sup>250</sup> One staff member who participated in the development of ERISA has indicated his belief that while there may be a short-run movement toward Target Benefit Plans, in the long run, employee resistance will prevent any significant change. Gordon, *The Implications of Federal Minimum Standards for Private Pension Plans*, 27 NAT'L TAX J. 437, 440 (1974).

<sup>251</sup> Target benefit plans are subject to the contribution limits imposed on defined contribution plans, PRIVATE PENSION TAX REFORM, H.R. REP. NO. 779, 93d Cong., 2d Sess. 119 (1974), which will make it more difficult to utilize them to provide very large benefits for older employees with many years of past service at the time the plan is adopted. Further, such plans ordinarily provide a death benefit equal to the amount of the account balance. Death benefits from a defined benefit plan may be much more limited.

earlier concerning the justification for the complete discrepancy between the two types of plans for purposes of plan termination insurance.

## V. SAVINGS BY INDIVIDUALS—NOTICE AND TAX RELIEF

Part A of this Section discusses whether employees who will *not* obtain the protection of a private pension plan will be warned early enough so they will have time to provide an adequate retirement income on their own. Part B considers the possibility of a tax incentive for such saving.

### A. Information to Employees

Unquestionably, many employers will not have retirement programs. Employees of such enterprises will know, as they have always known, that they must provide for themselves. At the other extreme, at least with a defined benefit plan, once a pension benefit, not in excess of the guaranteed limits and in effect for five years, has vested, the employee can assume it will be paid.<sup>252</sup> As discussed above, there may be more uncertainty in a defined contribution plan. The employee always bears the risk of investment performance and under a target benefit plan, there may be confusion as to the amount of the benefit which has been funded.

Misunderstanding may be minimized by ERISA's requirements for distribution of information to employees. Participants are to receive a summary description of the plan in a manner designed to be understood by the average participant.<sup>253</sup> A summary of any material modification is to be issued annually and a revised summary is to be distributed every five or ten years, depending upon whether there are amendments in the interim.<sup>254</sup>

The summary is to set forth the plan provisions providing for non-forfeitable pensions and the circumstances which may result in denial or loss of benefits.<sup>255</sup> In addition, each participant is entitled upon request, made no more often than once each year, to a statement which would indicate the benefits accrued and the value of his non-forfeitable benefits, or the date when such benefits will become non-forfeitable.<sup>256</sup> It would have been better for these reports to have been mandatory, but hopefully individuals will learn to make an annual request. These statements also would be more useful if they indicated the dollar amount that would be guaranteed in the event of a plan termination.

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<sup>252</sup> See Section III, Part B *supra*.

<sup>253</sup> ERISA §§ 102(a)(1), 104(b)(1)(A), 29 U.S.C. §§ 1022(a)(1), 1024(b)(1)(A), (Supp. IV, 1975).

<sup>254</sup> ERISA § 104(b), 29 U.S.C. § 1024(b) (Supp. IV, 1975).

<sup>255</sup> ERISA § 102(b), 29 U.S.C. § 1022(b) (Supp. IV, 1975).

<sup>256</sup> ERISA § 105(a), (b), 29 U.S.C. § 1025(a), (b) (Supp. IV, 1975).

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If a worker has stayed with one employer, uncertainty as to accrued but unvested pensions will be eliminated after no more than 15 years of service after age 22. This is the longest period permitted by ERISA before 100 percent vesting is required. However, employees who have changed jobs may remain unsure of a pension until quite close to their retirement.

Nevertheless, despite the room for improvement, ERISA clearly has improved the odds that an employee will know and understand his chances for a pension. It also has attempted to make saving for retirement less painful for those who must do so on their own.

### B. Individual Retirement Accounts

The long-standing use of tax incentives to encourage retirement savings for lower income workers undoubtedly suggested a turn in that direction when Congress sought to encourage individual savings. Thus, the Internal Revenue Code now allows a tax deduction for 15 percent of compensation, up to a maximum of \$1,500 per year, for contributions to an Individual Retirement Account (IRA).<sup>257</sup> This does not seem a promising route to the desired goal, however, and it is therefore doubly unfortunate that the idea was not implemented in the manner most likely to reduce the risk of tax inequity.

IRAs are a threat to the policy of promoting qualified plans. The tax advantage to the wealthy under a qualified plan is tolerated as a means of encouraging provision for the lower paid, who cannot be expected to save on their own. There is no similar reason to allow an IRA for the wealthy. At least, Congress should have limited the use of IRAs to relatively low income persons for whom government aid in saving for retirement is justified.

It is particularly unfortunate that IRAs are available to individual owners of a business or shareholder employees, who have the power to initiate a company-wide plan.<sup>258</sup> Because of the strict limits on contributions to an IRA there is a continued incentive to establish a richer company-wide plan. Still some, who would have adopted a plan which would include their employees, will now turn to an IRA. The latter choice may be reinforced by the possibility of providing past-service benefits under an employer plan even for years in which contributions were made to an IRA.<sup>259</sup>

The availability of IRAs to the wealthy is even more troublesome in light of the fact that the poor are not likely to use them to an appreciable extent.<sup>260</sup> Canada has a similar program. In 1969, 12 years

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<sup>257</sup> INT. REV. CODE OF 1954, § 219.

<sup>258</sup> Goetz, *Tax Aspects of the New Pension Reform Law*, 1975 U. ILL. L. FORUM 143, 169-70. See *Hearings on Tax Proposals Affecting Private Pension Plans Before the House Comm. on Ways & Means*, 92d Cong., 2d Sess., pt. 1, at 106 (testimony of Edwin S. Cohen, Ass't Sec'y of the Treasury for Tax Policy).

<sup>259</sup> HOUSE REP., *supra* note 251, at 127.

<sup>260</sup> *Hearings*, *supra* note 258, at 401, 402 (statement of Andrew J. Biemiller on behalf

after adoption of the program, only about 1.2 percent of all returns filed by persons earning less than \$10,000 a year claimed deductions for contributions to individual retirement programs, while over 35 percent of those persons earning in excess of \$25,000 were participating.<sup>261</sup> In fact, taxpayers earning over \$15,000 (representing less than 3 percent of all returns) made over 50 percent of the contributions.

Another major difficulty is the denial of IRAs to employees participating in employer sponsored plans even if they do not have a vested interest.<sup>262</sup> Congress wished to avoid the double coverage which would arise should the employer contributions become vested.<sup>263</sup> On the other hand, with 10 year vesting and a one-year waiting period for participation, it is not unlikely that an individual can, even after ERISA, achieve nearly constant participation without ever earning a benefit.

It would have been better to allow non-vested participants to make deductible contributions, with the proviso that should they ever obtain a vested right to a pension based upon the earnings on which the contribution to the IRA was based, the value of the IRA will become taxable immediately, or over a specified period. A similar rule could be established with respect to newly established employer plans which provide past-service benefits, at least for IRAs maintained for people who have control over establishment of the plan.

It seemed to me that the primary beneficiaries of IRAs would be the relatively high paid, or at least those who already planned on saving and would just transfer their bank account into an IRA.<sup>264</sup> In part, this would be the result of inertia by those who had very little to gain. ERISA's provision for employer sponsored IRAs,<sup>265</sup> and the extensive advertising undertaken by the banking and insurance communities, may indicate somewhat wider use than I envisioned. Nevertheless, while the returns are not yet in, it would be very surprising if IRAs significantly fill the gap between Social Security and pre-retirement earnings. The poor without adequate retirement protection are likely to remain so.

of AFL-CIO). Compare Gold, *Tax Deductions for Individuals Retirement Saving*, 25 NATL TAX J. 585 (1972).

<sup>261</sup> See *Hearings Before the Subcomm. on Private Pension Plans, Sen. Comm. on Finance*, 93d Cong., 1st Sess. 1166; 1177 (1973) (testimony of Norman H. Tarver—Table No. 5). The level of participation by high-income persons in Canada may be more than can be expected in the U.S. since Canada does not preclude deductions for those who are also participating in employer-sponsored programs. Mr. Tarver believes that my use of the statistics in the text is misleading because it omits the higher level of employee contributions to employer maintained plans which are made by the low income. See *id.* at 1193-94 (supplementary statement).

<sup>262</sup> INT. REV. CODE OF 1954, § 219(b)(2).

<sup>263</sup> HOUSE REP., *supra* note 251, at 127.

<sup>264</sup> *Hearings, supra* note 258, at 306, 309 (statement of Daniel Halperin).

<sup>265</sup> INT. REV. CODE OF 1954, § 408(c). In effect, this sanctions salary reduction plans, see text at notes 108-10 *supra*, but limits the exclusion of income to the \$1,500 IRA maximum.

## VI. EQUITY IN THE TAX BURDEN

At the present time, we accept an annual revenue loss of nearly \$6½ billion,<sup>266</sup> attributable to the special tax benefits to qualified plans in order to finance retirement benefits for about 50 percent of the work force.<sup>267</sup>

Analysis of who is covered leads to one obvious conclusion. The uncovered portion is heavily drawn from employees of small companies who tend to be at the lower end of the wage scale. For example, one survey<sup>268</sup> shows that in companies where employees earn an average hourly wage of less than \$3, the percentage of workers covered is 18 percent, while if the average earnings are over \$7 per hour the percentage rises to 88 percent. Moreover, the coverage in companies with over 500 employees is 93 percent as compared to only 38 percent for those companies with under 100 employees. As stated above, IRAs are not likely to be attractive to people at the income level where the uncovered predominate. On the other hand, some people take advantage of the available tax benefits to build up a retirement nest egg of well in excess of \$1 million. The Treasury has indicated that the upper 8 percent of wage earners receive 50 percent of the tax benefits while the lower 50 percent obtain less than 6 percent of the benefits.<sup>269</sup> It seems obvious that the fairness of the tax law is severely compromised by this situation, and in particular, by the inadequate limits on the benefits that can be received under qualified plans.

Section A sets forth the existing rules on maximum benefits from qualified plans and Section B discusses the case for much more stringent restrictions. Of course, employers would not be prevented from providing a larger retirement income on a non-qualified basis. This raises the question of whether deferral of tax on such earnings until after retirement is an unfair tax advantage. Section C deals with this question.

<sup>266</sup> HOUSE COMM. ON THE BUDGET, H. REP. NO. 145, 94th Cong., 1st Sess. 53-55 (1975); EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE U.S. GOVT FISCAL YEAR 1976, SPECIAL ANALYSES, Table F-1, at 108-09 (1975).

<sup>267</sup> SENATE COMM. ON FINANCE, PRIVATE PENSION PLAN REFORM, S. REP. NO. 383, 93d Cong., 1st Sess. 13 (1973). The frequently cited 50% coverage refers to private non-farm workers. A recently published survey based upon 1972 finds 63% of these workers are participating in private plans. Bell, *Prevalence of Private Retirement Plans*, 98 MONTHLY LABOR REV. No. 10, at 17, 18 (Oct., 1975). The percentage of retirees actually receiving benefits is much lower. Of those who initially applied for Social Security benefits in fiscal year 1969-1970, only about 35% (including about one-half of the males) had pension coverage from their longest job.

<sup>268</sup> See Bell, *supra* note 267.

<sup>269</sup> Statement of Frederic W. Hickman, then Ass't Sec'y of the Treasury for Tax Policy, from *Pension and Profit Sharing Plans: The Quintessential Tax Shelter* 10, before the 25th NAT'L CONF. OF THE TAX FOUNDATION (Dec. 5, 1973).

A. *Restriction of the Size of Benefits*1. *Prior Law*

Prior to ERISA, there were no specific limits on the amount of benefits payable under a qualified plan established by a corporation. However, contributions to a profit-sharing plan could not be currently deducted if they exceeded 15 percent of pay.<sup>270</sup> When a profit-sharing and pension plan were in effect for the same employees, the combined current deduction limit was 25 percent of compensation.<sup>271</sup> In addition, the Internal Revenue Service took the position that a defined benefit plan could not provide a pension in excess of the employee's highest salary averaged over a reasonable period.<sup>272</sup> Still, if the President of a corporation earned \$250,000 per year, and the corporation's plan paid a benefit of 70 percent of pay, the President could have received a pension of \$175,000 per year. Such a pension would require an accumulation of at least \$1,750,000.<sup>273</sup>

On the other hand, there were severe limitations on contributions on behalf of self-employed individuals. These contributions could not exceed the lesser of \$2,500 or 10 percent of pay.<sup>274</sup>

2. *The Effect of ERISA*

A limit has been placed on all types of qualified plans. Generally, a defined benefit plan cannot pay an annual pension of more than 100 percent of average annual earnings during the best three years of employment, up to a \$75,000 maximum.<sup>275</sup> Annual additions (including employer contributions, forfeitures and certain employee contributions) to the account of any individual employee under a defined contribution plan may not exceed 25 percent of his compensation, or \$25,000, whichever is the lesser.<sup>276</sup> The \$25,000 and \$75,000 amounts are subject to adjustment as the cost of living rises.<sup>277</sup>

If both types of plans have been adopted for the same employees, one or both of the separate limits will be reduced, so that the

<sup>270</sup> INT. REV. CODE OF 1954, § 404(a)(3).

<sup>271</sup> *Id.* § 404(a)(7).

<sup>272</sup> Rev. Rul. 72-3, 1972-1 CUM. BULL. 105.

<sup>273</sup> For purposes of determining the benefit derived from employee contributions, ERISA assumes that a \$1.00 single life annuity commencing at age 65 requires a \$10.00 accumulation at that time. ERISA § 204(c)(2)(B)(ii), 29 U.S.C. § 1054(c)(2)(B)(ii) (Supp. IV, 1975); INT. REV. CODE OF 1954, § 411(c)(2)(B)(ii).

<sup>274</sup> INT. REV. CODE OF 1954, § 404(e) as it existed prior to ERISA.

<sup>275</sup> INT. REV. CODE OF 1954, § 415(b)(1). The Code permits the \$75,000 benefit to begin at age 55 and be in the form of a 100% joint and survivor annuity for the employee and his spouse. *Id.* § 415(b)(2).

<sup>276</sup> INT. REV. CODE OF 1954, § 415(c).

<sup>277</sup> *Id.* § 415(d). The IRS has announced that for 1976, the applicable amounts are \$26,825 and \$80,475, respectively, IR 1571, PRENTICE HALL, PENSION AND PROFIT SHARING ¶1107147.

combination plan cannot exceed 140 percent of the separate limit.<sup>278</sup> For example, if the defined contribution plan is fully utilized, the maximum pension under the defined benefit plan is 40 percent of pay or \$30,000, whichever is less. Still, the combined accumulation for any one individual under the ERISA limits can easily be close to \$2 million.<sup>279</sup>

The disparity between corporate employees and self-employed individuals was narrowed by increasing the annual limit on deductible contributions for the latter to the lesser of \$7,500, or 15 percent of income.<sup>280</sup>

### B. *The Case for Benefit Restrictions*

Noting that the disparity between employee-shareholders and the self-employed was a "distinction in treatment . . . not based on any difference in reality," which led to artificial pressure for incorporation of professional practices, the Administration suggested<sup>281</sup> increasing the annual limit for deductible contributions on behalf of self-employed individuals. While, as noted, the distinction is reduced, a substantial difference "not based on reality" remains. Although the Administration was not brave enough to face the complaints of those whose tax benefits would be reduced if similar limits were placed on corporate plans, it clearly indicated a belief that unlimited pensions would be an unwarranted tax advantage. What justifies this position? If an employer can provide a 70 percent pension to someone earning \$10,000 a year, what is the objection to a similar pension to someone earning \$200,000?

#### 1. Measurement of Tax Benefit

As described earlier, the advantage of a qualified plan is the ability of the employer to deduct a contribution, without there being current tax to the employee. Neither the employer nor the employee pays tax on income, which one or the other has earned, until the em-

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<sup>278</sup> INT. REV. CODE OF 1954, § 415(e).

<sup>279</sup> As stated in note 273 *supra*, Congress has assumed a single life annuity at age 65 of \$75,000 would require an accumulation of \$750,000. If the \$75,000 were paid in the form of a 100% Joint and Survivor annuity for the benefit of the employee and his spouse, this could increase the required accumulation to approximately \$960,000. See Rev. Rul. 71-446, 1971-2 CUM. BULL. 187, § 8.02. If the benefit were payable as a joint and survivor annuity at age 55, the required accumulation could be approximately \$2 million. See *id.* § 10.021. According to advertisements for self-employed plans placed by the Bowery Savings Bank, a deposit of \$10,000 per year, the maximum contribution permitted for an employee utilizing the defined benefit plan to the limit, would, if made over a 30-year period, produce a total accumulation in excess of \$1-¼ million at Bowery's current maximum annual rate—8.17% with daily compounding. Congress estimated an accumulation of about \$550,000, assuming a 6% rate and 25 years. SENATE REP., *supra* note 267, at 29.

<sup>280</sup> INT. REV. CODE OF 1954, § 404(e).

<sup>281</sup> *Hearings, supra* note 258, at 6, 8 (statement of Richard M. Nixon).



ployee receives a distribution.<sup>282</sup>

In essence, the deferral of tax amounts to an interest free loan from the Treasury, to the employer if benefits are not vested, and to the employee if they are. Complete deferral can also be described as the equivalent of imposing the tax initially but exempting any earnings on the investment of the after tax amount.<sup>283</sup> For example, assume a taxpayer in a 50 percent marginal tax bracket with \$10,000 of pre-tax income available for investment. After tax, this individual will have \$5,000 to invest which at a 10 percent return will produce \$500 per year before taxes. If tax is deferred and \$10,000 can be invested, the return at 10 percent is \$1,000 before tax and \$500 after payment of tax at the 50 percent rate. The \$500 after-tax return is equivalent to tax free income, because it is the equivalent of the pre-tax return from the \$5,000 investment which would have been made in the absence of special tax relief. Since the income of the qualified plan is also exempt from tax, the tax free return on the original contribution is extended to the income provided by the reinvested earnings.

If the benefit of a qualified plan is visualized as an interest-free loan, it is clear that for each dollar of retirement benefit purchased, the higher the tax bracket, the greater the "loan."<sup>284</sup> For example, assume, at a given age, it will take a set-aside of \$1,000 per year to finance a life annuity of \$5,000. If the employee is in the 25 percent bracket, the Treasury's interest free loan is \$250 per year; for the employee in the 50 percent bracket, the loan is twice as much, or \$500 per year. Moreover, the above example assumed an equal contribution. More likely, the contribution for the higher bracket individual will be greater, since it is not discriminatory to provide a greater dollar benefit or make a larger contribution on behalf of the higher paid, so long as the ratio of contributions or benefits to salary is uniform.<sup>285</sup>

If one looks at deferral as a means of providing tax free investment income, qualified plans may appear fair, since all receive equal tax free treatment. This is a satisfactory result for those who believe that investment income should not be taxed, or suggest that the only reason to tax investment income is to impose a burden on wealth.<sup>286</sup> A tax on wealth may be said to be inappropriate if the accumulation will be spent by the individual within his own lifetime during his retirement years.<sup>287</sup>

Nevertheless, tax free income is obviously an increasingly greater

<sup>282</sup> See text at notes 14-15 *supra*.

<sup>283</sup> Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1126 (1974).

<sup>284</sup> One Treasury estimate shows that the "tax subsidy" more than doubles the pension for an individual earning \$30,000 at age 35 while it increases it by less than 40% for an individual earning \$10,000. See Hickman, *supra* note 269, at 14.

<sup>285</sup> INT. REV. CODE OF 1954, § 401(a)(5).

<sup>286</sup> See Andrews, *supra* note 283, *passim*.

<sup>287</sup> *Id.* at 1167-69.

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benefit, as the tax bracket increases, and a clear perversion of the progressive tax ideal. Moreover, even a burden on wealth seems appropriate when the accumulation reaches in excess of one-half million or one million dollars. With the top tax rate on earned income at 50 percent,<sup>288</sup> it seems impossible to argue that a tax break is needed for the well-to-do to provide for retirement.

### 2. Critique of ERISA

The only justification for unlimited tax subsidized retirement benefits is that it is essential to insure the establishment and maintenance of plans. Unless the higher paid can provide an unlimited pension for themselves in a tax preferred manner, they will be insufficiently motivated to provide for the lower paid.<sup>289</sup> There are two answers to this assertion:

(a) If it is true, it represents an expensive way to provide pension coverage for the lower paid; the loss of tax equity is too great.

(b) There is no evidence that it is correct.

Tax relief to help build a pension of over \$100,000 a year is especially galling in light of the fact that 50 percent of the working population, heavily drawn from the lower end of the scale, is not covered by the private pension system. Why should these people suffer an increase in tax burden because of the extreme tax savings for those who receive such large pensions? Moreover, because the higher the tax bracket, the greater the aid, a high paid individual may still get as much help, absolutely or even in proportion to pay, despite the fact that his pension is limited to a lower percentage of earnings.<sup>290</sup> In short, there can be no justification for federal aid to accumulate pensions in the amount permitted by ERISA.<sup>291</sup>

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<sup>288</sup> INT. REV. CODE OF 1954, § 1348.

<sup>289</sup> See *First Panel Discussion on Private Plan Reform, Subcomm. on Private Plans, Sen. Comm. on Finance, 93d Cong., 1st Sess. 77, 91 (1973)* (testimony of Carrol Savage in Committee Print of Testimony to be Received May 31, 1973).

<sup>290</sup> For example, compare the following cases, assuming a qualified pension can be based on only the first \$50,000 of earnings and that the hypothetical plan calls for a 50% benefit.

<u>Earnings</u>	<u>Benefit</u>	<u>Assumed Tax Bracket</u>	<u>Assumed Contribution</u>	<u>Interest Free Loan</u>	<u>Loan as % of Compensation</u>
\$20,000	\$10,000	25%	\$2,000	\$ 500	2-½%
\$50,000	\$25,000	50%	\$5,000	\$2,500	5%
\$100,000	\$25,000	50%	\$5,000	\$2,500	2-½%

<sup>291</sup> Limitations on the size of pensions from qualified plans has had support from a wide spectrum. See PUBLIC POLICY AND PRIVATE PENSION PROGRAMS, A REPORT TO THE

If Congress were worried about the effect of benefit limits on the establishment of plans, it should have viewed ERISA as a first step. If the limit appears not to have any undue effect on the existence of plans it could be *lowered* in actual amount or in substance by inflation. It is unfortunate that the Act actually contains a built-in *escalator* for changes in the cost of living.

There is also an undesirable aspect to the manner in which the limitation is applied. Aside from the absolute maximum of \$75,000, ERISA limits the retirement benefit to 100 percent of final pay, subject to a post-retirement cost of living adjustment.<sup>292</sup> The overall limit could alternatively be stated as a \$75,000 limitation on the amount of earnings which can be taken into account under a qualified plan. However, while ERISA does not permit more than \$100,000 of salary to be taken into account in the case of plans established by sole proprietors, partnerships or subchapter S corporations,<sup>293</sup> no limit is placed on the salary which can be considered under corporate plans. This has the effect of permitting those who make \$200,000, for example, to cut the pensions of lower paid to 37-½ percent of earnings, while still providing the maximum pension of \$75,000 for themselves.

### 3. Stricter Limits

I would hope that ERISA is not the last word on maximum benefits from qualified plans and that any further reduction will be universally applicable. If this is not politically unacceptable, then it is not unreasonable to examine individual plans to see what proportion of the persons covered are low paid, or what portion of the total dollar value of the benefits is allocated to the low paid. If the benefits under the plan are predominantly for higher paid individuals, there is little reason to encourage the plan as it then exists. It could be brought into line by limiting the benefits to the high paid to a specified dollar amount,<sup>294</sup> or more logically, to that amount necessary to produce the required percentage benefit for the lower paid.

Further, given the present limits on the self-employed, it is sensible to impose limitations on persons who are substantial owners of a business regardless of the form of business organization.<sup>295</sup> At least this removes the artificial pressure for incorporation.

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PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS 59 (1965); *Legislative Recommendation of the Comm. on Employee Benefits of the Tax Section of the Am. Bar Ass'n*, 24 TAX LAWYER 901, 905 (1971).

<sup>292</sup> INT. REV. CODE OF 1954, § 415(d)(1)(C).

<sup>293</sup> *Id.* § 401(a)(17).

<sup>294</sup> The Senate bill which led to ERISA would have imposed limits on the size of benefits for shareholder employees only if all 2% stockholders together account for 25% of the total accrued benefits. SENATE REP., *supra* note 267, at 29. See also *Hearings, supra* note 258, at 322 (statement of Rep. Byrnes, then ranking minority member of Ways & Means).

<sup>295</sup> The Senate Finance Committee attempted to accomplish this on several occasions. See Chadwick & Foster, *Federal Regulation of Retirement Plan: The Quest for Parity*, 28 VAND. L.

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### C. Non-Qualified Deferred Compensation

Of course, any limitation on the amount of pension payable from a qualified plan would not restrict the compensation payable to employees on retirement or otherwise.<sup>296</sup> It would be intended only to curb the special tax relief. In this connection, it must be noted that a significant part of the deferred compensation of highly paid executives is determined on an individual basis,<sup>297</sup> and not as part of a qualified plan. Under ERISA this may continue on an unfunded basis.<sup>298</sup> If compensation is dependent on the performance of substantial future services, it seems correct to defer taxation until the amount is vested.<sup>299</sup> If non-forfeitable compensation is funded by deposit in a trust fund or purchase of an annuity contract, in a manner so that the employee is not relying on the credit of the employer, then it is taxable immediately, even though distribution to the employee is deferred.<sup>300</sup> If this rule is to remain unchanged,<sup>301</sup> the issue is whether there should be immediate taxation of an unfunded<sup>302</sup> vested benefit.

Non-qualified plans do not, at least in the case of taxpaying employers, cause the same revenue loss as does deferral under a qualified plan. As noted above, the price of such deferral on a non-qualified basis is a delay in the tax deduction for the employer until the employee is taxed on the income.<sup>303</sup> Nevertheless, many people believe tax deferral provides an unwarranted advantage which should be ended or reduced.<sup>304</sup> Some may ask why funding makes a difference? If one were employed by General Motors, for example, there is

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REV. 641, 659 n.135 (1974); SENATE REP., *supra* note 267, at 9, 29, 121. For a similar attempt limited to professional corporations, see SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1969, S. REP. NO. 552, 91st Cong., 1st Sess. 270-72 (1969). The Senate report on ERISA expressed the belief that plans of closely-held corporations provided a lower proportion of the benefit for the rank-and-file employees. SENATE REP., *supra* note 267, at 29.

<sup>296</sup> Thus, ERISA provides a special exemption for an "excess benefit plan" maintained to provide benefits in excess of the § 415 limits. ERISA § 3(36), 29 U.S.C. § 1002(36) (Supp. IV, 1975). See ERISA §§ 4(b)(5), 201(7), 301(a)(9), 29 U.S.C. §§ 1003(b)(5), 1051(7), 1081(a)(9) (Supp. IV, 1975).

<sup>297</sup> The individual can elect to defer the payment of compensation, at least as long as the election is made prior to the beginning of the year in which the amount is earned. Rev. Rul. 69-650, 1969-2 CUM. BULL. 106; Rev. Proc. 71-19, 1971-1 CUM. BULL. 698.

<sup>298</sup> ERISA § 301(a)(3), 29 U.S.C. § 1081(a)(3) (Supp. IV, 1975).

<sup>299</sup> See INT. REV. CODE OF 1954, § 83(a).

<sup>300</sup> INT. REV. CODE OF 1954, §§ 402(b), 403(c). See Rev. Rul. 60-31, 1960-1 CUM. BULL. 174 (Ex. 4).

<sup>301</sup> See text following note 247 *supra*. The American Bar Ass'n Section on Taxation has suggested that deferral be allowed for funded plans regardless of coverage. See *Hearings, supra* note 258, at 229, 239.

<sup>302</sup> There may be funding in the sense that an amount is set aside and invested in securities or insurance. This does not result in current tax unless the amount set aside is not part of the employer's general assets and is not reachable by creditors. See Rev. Rul. 68-99, 1968-1 CUM. BULL. 193; David Centre, 55 T.C. 16 (1970).

<sup>303</sup> See text at notes 239-44, 11-13 *supra*.

<sup>304</sup> See H.R. REP. NO. 413, 91st Cong., 1st Sess. 90-91 (1969).

not much of a distinction between reliance on the employer's credit and a deposit in a trust fund. If \$5,000 of current compensation were set aside for payment in the future, it is easy to determine the amount of current tax even though no specific trust is established.<sup>305</sup> Compensation is harder to measure, however, if the employer promises to pay a specific amount at retirement. While it may not be unduly difficult to develop tables to measure both current compensation and hypothetical earnings to the employee under such arrangements,<sup>306</sup> it may be inadvisable to do so unless deferral is a significant advantage.

Tax deferral will, most obviously, result in tax reduction in the following circumstances: (1) the employee's tax bracket after retirement is lower than it is while he is employed; (2) the employee is in a higher tax bracket than the employer. The deferral of income causes the employer to lose the deduction but the immediate tax is paid at its bracket rather than the higher rate imposed on the employee. There is, in effect, an interest-free loan on the difference in tax for the period of deferral.

With regard to the first circumstance, averaging income so that the highest marginal rate is determined by spreading income equally over a lifetime may be a worthwhile goal. It is troublesome, however, to permit the highly paid to do so when a similar opportunity is not as available to all taxpayers. Nevertheless, the adoption of the 50 percent maximum tax on earned income makes it much less likely that the really high paid executive will have a significantly lower rate after retirement than he has while working. A lower post-retirement rate may occur most frequently when such persons are investing in the tax shelters that keep them from currently utilizing the maximum tax.<sup>307</sup> But this lower rate will ordinarily have to be the result of substantially reduced income since the maximum tax is unavailable with respect to many forms of deferred compensation.<sup>308</sup>

With regard to the second circumstance the existence of the maximum tax also makes it much less likely that the employee's rate of tax will be significantly higher than the employer's. It seems, therefore, that the adoption of section 1348, and its inapplicability to most forms of deferred compensation<sup>309</sup> has reduced the tax benefit of deferral. The primary advantages would seem to be two factors that are much less obvious.

If a corporation invests the deferred amounts in dividend paying stock, it gets an 85 percent dividend received deduction<sup>310</sup> the benefit

<sup>305</sup> See Rev. Rul. 60-31, 1960-1 CUM. BULL. 174 (Ex. 1, 2).

<sup>306</sup> See Treas. Reg. § 1.403(b)-1(d)(4) (1966).

<sup>307</sup> INT. REV. CODE OF 1954, § 1348(b)(2)(B).

<sup>308</sup> *Id.* § 1348(b)(1).

<sup>309</sup> See Halperin, *Maximum Tax Not for Those Indulging in Deferred Compensation and Tax Preferences*, 1972 MAJOR TAX PLANNING 619, 628-38 (24th U.S.C. Tax Institute).

<sup>310</sup> INT. REV. CODE OF 1954, § 243(a)(1).

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of which can be passed on to the employee.<sup>311</sup> Put another way, while only 15 percent of the dividends are taxed, the deduction for compensation paid can be the full amount of the dividend.<sup>312</sup> This clearly is unwarranted.<sup>313</sup> If his top tax bracket is over 60 percent and he has more than \$50,000 in capital gains, the employee can also get the advantage of the lower corporate rate for such income.<sup>314</sup> Moreover, by shifting the capital gain to the corporation, the employee can minimize both minimum and maximum tax problems.<sup>315</sup>

These advantages are significant and no immediate cure is apparent. The ideal would be to segregate the assets which represent the employee's share and to treat the income thereon as if earned by the employee. Immediate taxation of compensation does not suffice because the real advantage is the taxation of investment income. It may be that funding should be required so that the assets can be isolated. Perhaps, it would then not be necessary to impose current taxation even though the employee's interest is vested and funded.

One final point should be noted. It is assumed that there is often no tax advantage to the employee's deferral of income because it will be balanced by the employer having to defer the deduction. In a sense, the interest-free loan to the employee comes from the employer, rather than the government, and will be taken into account in the bargaining between the parties. However, this assumed interest-free loan is a benefit to the employee, which will not be quantified in proxy material, or the like, and may be hidden from the scrutiny of shareholders. Thus deferred compensation may be more of a problem for the SEC and the accountants than it is a question of tax policy.

<sup>311</sup> The tax savings from a deduction at the 50% bracket enables the corporation to distribute \$2.00 at a net cost of \$1.00. Therefore, if the corporation earns \$100 in dividends, it will distribute \$185 to the employee:

Dividend		\$100.00
Taxable Income 15%	\$15.00	
Tax at 50%		7.50
After Tax Income		92.50
Distribution at \$2.00 for \$1.00		185.00

If the employee is in a 50% bracket, the extra distribution will be sufficient to pay his income tax and he will retain \$92.50, the same amount that the corporation had after tax. In these circumstances, the only effective tax on the dividend income is at the corporate level.

<sup>312</sup> In the example in note 311, the corporation earned a \$100 dividend which led to \$15 of taxable income and a \$92.50 deduction. (The deduction would have been \$100 had the pre-tax amount been distributed).

<sup>313</sup> The purpose of the dividend-received deduction is to prevent "triple taxation" of earnings at the level of the corporate earner, the corporate investor and the individual shareholder. This possibility does not arise if the corporate investor offsets the taxable dividend by a deductible payment for salary or interest. The dividend-received deduction should be limited, if feasible, to dividend income distributed to shareholders.

<sup>314</sup> Compare INT. REV. CODE OF 1954, § 1201(a), with *id.* §§ 1201(b)(2)(A), 1201(d)(3), 1202.

<sup>315</sup> See INT. REV. CODE OF 1954, §§ 57(a)(9)(A), 56(a)(1), 1348(b)(2)(B).

VII. CONCLUSION AND PROGRAM FOR THE FUTURE

Congress certainly did not alleviate all of the problems of the private pension system. In fact, it probably could not have passed so massive a bill without making some things worse, at least during the shake down period as people adjust to the new rules. Nevertheless, ERISA is a giant step forward, if the private pension route is to be followed.

*A. Improvements to Private Pensions*

ERISA has strengthened the private system by making the promise of a pension more secure. The picture as to tax equity is harder to judge. The question depends on the utilization of IRAs and the larger deduction for the self-employed. If this is top-heavy enough, it will outweigh the mild improvement from the new benefit limits and the conditions on coverage and vesting. This article has suggested that the private system could be further improved in the following manner.

Title I should require more rapid vesting if studies indicate loss of significant accrued benefits for periods in which retirement savings normally takes place, at least if the cost of the benefit is reflected in the wage rate. The Internal Revenue Code should at a minimum require vesting of significant accrued benefits earned during periods in which sound public policy suggests that savings for retirement should ideally occur.<sup>316</sup> Further, the vesting standard of the Internal Revenue Code should preclude discrimination in favor of the highly paid.<sup>317</sup> Service for vesting purposes should not be required to be continuous unless absolutely essential for administrative reasons.<sup>318</sup> In any event, service after a break-in-service should have the same effect in defined contributions plans as it does in defined benefit plans.

I have also suggested that employee contributions be prohibited as a condition for participation<sup>319</sup> and that plans for salaried workers only be considered discriminatory unless the hourly workers are in a separate collective bargaining unit.<sup>320</sup> The procedure for integration with social security should be modified to allow integration only when the plan benefit after integration will, in combination with social security, assure full replacement of income immediately prior to retirement.<sup>321</sup>

Target benefit plans and insured individual contract plans should be made subject to plan termination insurance with respect to their actual past-service benefit. If this is not acceptable and it appears

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<sup>316</sup> See text at notes 44-46 *supra*.

<sup>317</sup> See text at notes 60-63 *supra*.

<sup>318</sup> See text at notes 75-76 *supra*.

<sup>319</sup> See text at notes 122-23 *supra*.

<sup>320</sup> See text at note 131 *supra*.

<sup>321</sup> See text at notes 129-30 *supra*.

likely that a significant number of defined benefit plans are in danger of being replaced by target benefit plans, then consideration might be given to phasing in the guarantee of new benefits over a longer than 5 year period.<sup>322</sup>

The tax treatment of non-qualified plans for rank-and-file employees could conceivably be changed to defer both the employer deduction and taxation of employees if studies indicate that a significant revenue loss is unlikely and that the tax rules have harmed the effort to promote retirement security.<sup>323</sup> It may also be advisable to require funding for non-qualified plans for the higher paid and accord similar deferral, particularly if I am right in my belief that the major tax benefit to deferral is the treatment of investment income under present law.<sup>324</sup>

Tax equity requires that the limits on benefits from qualified plans be further reduced.<sup>325</sup> Moreover, if IRAs are to be continued, they should be denied to all those who earn over a specified amount and in particular to the self-employed and substantial shareholders of corporations.<sup>326</sup> Employees with non-vested pensions should be allowed to contribute to IRAs. Perhaps a tax credit should be considered if IRAs are not being utilized by low income workers to the desired extent. Inequities in the tax law would further be mitigated by the elimination of the special treatment of distributions in a lump sum<sup>327</sup> or in the form of employer securities<sup>328</sup> and by the repeal of the estate tax exclusion.<sup>329</sup> In fact, investments in employer securities by qualified plans should be prohibited.<sup>330</sup>

Finally, the annual statement to employees of accrued and vested benefits should be made mandatory and should indicate the portion guaranteed if the plan were to terminate.<sup>331</sup>

### B. Social Security as an Alternative

I have offered little hope that even with these improvements, the average family can expect to carry over approximately the same standard of living into their retirement years. Studies have indicated that this goal requires retirement income of from 70-80 percent of the last year's earnings.<sup>332</sup> Less than 100 percent replacement is needed because of elimination of work-related expenses, lower taxes on retire-

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<sup>322</sup> See text at note 210 *supra*.

<sup>323</sup> See text at note 247 *supra*.

<sup>324</sup> See text following note 315 *supra*.

<sup>325</sup> See text at notes 290-95 *supra*.

<sup>326</sup> See text at notes 258-63 *supra*.

<sup>327</sup> See text at notes 160-63 *supra*.

<sup>328</sup> See text at note 212 *supra*.

<sup>329</sup> INT. REV. CODE OF 1954, § 2039(c).

<sup>330</sup> See Section III, Part D *supra*.

<sup>331</sup> See text at note 256 *supra*.

<sup>332</sup> See Henle, *Recent Trends in Retirement Benefits Related to Earnings*, MONTHLY LABOR REV. No. 6, at 12, 18 (June, 1972).



ment income and the availability of Medicare.

For persons retiring in 1976, Social Security provides a benefit of at least 60 percent of the wages on which it is based.<sup>333</sup> If both spouses have reached retirement age, the addition of the spouse's benefit brings the total benefit up to at least 90 percent of covered wages.<sup>334</sup> If this benefit were based on the final year's earnings, it would be adequate to maintain the pre-retirement standard of living. Unfortunately, however, covered wages are determined by an average of at least nineteen years dating back to the time when the taxable wage base was only \$4,200. Thus, even though the maximum tax base for 1975 was \$14,100, the highest average earnings for benefit purposes is approximately \$7,000.<sup>335</sup> The combined husband and wife benefit would therefore be less than 50 percent if actual pre-retirement earnings were \$14,000.

Until now at least,<sup>336</sup> Social Security has not been geared to be sufficient to maintain the worker's pre-retirement standard of living,

<sup>333</sup> As described in note 335 *infra*, the maximum covered wages for a man retiring in 1976 is \$7,026 or \$585 per month. As of July 1976, this amount will increase to \$387.30 or approximately 60%. (The benefit payable on \$585 is \$364 or approximately 62%.) The ratio of benefit to wages is greater at lower earnings levels. See 40 Fed. Reg. 22291-96 (May 22, 1975).

<sup>334</sup> See 42 U.S.C. §§ 402(b)(2), 402(c)(3).

<sup>335</sup> See 42 U.S.C. § 415(b). Men retiring in 1976 must take account of wages on which Social Security taxes were paid for all years after 1950 and before the year they reached age 64. (After a brief transition period, this age will be 62 for men as it now is for women.) They may drop out the five lowest years and substitute any period of work after age 64 for the 6th etc. lowest year during the computation period. If the individual retiring in 1976 was 65 at the time, the last year in the computation period would be 1974. The computation period, thus, stretches over 24 years, of which the high 19 are used to compute the wages on which Social Security will be paid. If the worker always earned at least the maximum amount on which Social Security taxes were paid the calculation would be as follows:

Years	Wage Base	Total Wages	
1957-58(2)	\$ 4,200	\$ 8,400	
1959-65(7)	4,800	33,600	
1966-67(2)	6,600	13,200	
1968-71(4)	7,800	31,200	
1972 (1)	9,000	9,000	
1973 (1)	10,800	10,800	
1974 (1)	13,200	13,200	
1975 (1)	14,100	14,100	
19	÷	\$133,500	= \$7,026

See generally Ball, *Social Security Amendments of 1972: Summary & Legislative History*, 36 Soc. SEC. BULL. No. 3, at 3 (March, 1973); *Notes & Brief Reports*, 38 Soc. SEC. BULL. No. 7, at 33, 34 (July, 1975); Ball, *Social Security & Private Pension Plans*, 27 NAT'L TAX J. 467, 468-69 (1974).

<sup>336</sup> Assuming the Social Security Act remains unchanged, the built-in escalators in the system which increase both covered wages and the ratio of benefits to wages might, about 1995, begin to produce an increase in replacement level which, according to some estimates, would reach about 90% in the middle of the 21st Century. There appears to be some doubt that this will be allowed to happen. See Ball, *supra* note 335, at 468; Brittain, *Social Security Taxes: Problems and Prospects for Reform Revisited*, 4 TAX NOTES No. 6, at 18, 20 (Feb. 9, 1976).

even for a worker whose wages were always below the level subject to contributions under the Social Security Act. As noted, the private pension system is supposed to provide the difference but as this Article has described, it is very difficult to arrange this when the system is voluntary. Tax incentives can encourage behavior that would not be undertaken in an unregulated market. However, the more stringent the requirements placed upon private plans, the less likely they are to meet the employer's objective. It will therefore cost more in tax expenditures to purchase such programs. At some point, the cost becomes too great, and the attempt to coerce a private plan must be given up.

The Labor movement in particular urges improvements in Social Security as the only certain means of providing adequate retirement income.<sup>337</sup> Such proposals have run into opposition.<sup>338</sup> Social Security is financed by a highly visible payroll tax which will be difficult to increase significantly.<sup>339</sup> The cost of private pensions in the form of lower wages is more hidden. Forcing people to save for retirement is objectionable to some but may be tolerable when what is sought is a subsistence level of income. However, many believe the individual should be allowed to choose whether he wants to maintain his living standard after retirement or live it up while young and struggle along later. A worker may not have much to say about the level of the employer's pension plan, but he can exercise some choice in job selection. Finally, Social Security has been administered as an intergenerational transfer system.<sup>340</sup> Today's workers support those presently retired with the expectation that the next generation of workers will do the same for them. Under a private plan there is at least a partial build-up of assets which means the worker provides *for himself* to some extent. This may be preferred as a matter of equity or merely because it reduces spending and increases saving.<sup>341</sup>

### C. Compulsory Private Pensions

If it is not politically feasible to bring Social Security up to the required level, or more flexibility is desired than can be expected with a public program, the only alternative is to require employers to supplement the basic Social Security benefits, to the extent necessary to

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<sup>337</sup> See Seidman, *Future Structure of Social Security System and Interrelation with Private Pension Plans*, 27 NAT'L TAX J. 473, 477 (1974).

<sup>338</sup> See Ball, *supra* note 335, at 470-71. See also Remarks of John S. Nolan, Deputy Ass't Sec'y of the Treasury for Tax Policy, *New Developments Affecting Employee Benefits* 7, before the Federal Tax Institute of New England (Dec. 5, 1970); Bok, *Emerging Issues in Social Legislation: Social Security*, 80 HARV. L. REV. 717 (1967).

<sup>339</sup> See J. BRITAIN, *THE PAYROLL TAX FOR SOCIAL SECURITY* (1972); Ball, *supra* note 335, at 470.

<sup>340</sup> J. PECHMAN, H. AARON, M. TAUSSIG, *SOCIAL SECURITY PERSPECTIVES FOR REFORM*, 71, 173 (1968).

<sup>341</sup> Ball, *supra* note 335, at 471.

bring an employee's retirement income up to the desired level, say 60 to 80 percent of final earnings. This commitment could perhaps be met through a private retirement plan or, at the option of the employer, through contributions to a collective plan administered by the Social Security system.<sup>342</sup> In either case, this minimum coverage should be required to be given on the basis of full and immediate vesting. In tandem, therefore, the public and private retirement programs would be required to provide employees with retirement income at a level which will assure that they do not suffer an appreciable reduction in their standard of living on retirement.

Although a number of people<sup>343</sup> have suggested a compulsory private system, it is not yet a concept which has received much public discussion. Further, it will require additional study to work out the technical details. However, there are only two feasible alternatives if the goal of adequate retirement income is to be achieved. If Social Security will not be improved to achieve this objective on its own, a compulsory private system must be considered.

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<sup>342</sup> Finland apparently has such a compulsory system. See Note, *The Employee Retirement Income Security Act of 1974*, 26 SYR. L. REV. 539, 556 (1975).

<sup>343</sup> See, e.g., *Hearings on Tax Proposals Affecting Private Pension Plans Before the House Comm. on Ways & Means*, 92d Cong., 2d Sess., pt. 3, at 828, 829 (statement of Robert D. Paul); Grubbs, *An Adequate Retirement Income for Every American*, Address to the Social of Actuaries (Feb. 1972).