1991

Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky

Norman P. Stein

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I. INTRODUCTION

A. *OVERVIEW*

The tax treatment of qualified deferred compensation plans is generally reckoned to give rise to tax expenditures that can be justified only insofar as they contribute to our national retirement policy goals.[1] In an article in the *North Carolina Law Review*,[2] Professor Zelinsky takes issue with this view, arguing that the present treatment of qualified plans, while imperfect, "fits comfortably into our conception of a normative income tax without appealing to expenditure-type considerations such as the encouragement of retirement savings."[3] Professor Zelinksy terms his argument a classic defense of the status quo, but it is also an assault on the status quo, for if we need not turn to "expenditure type considerations" to justify the tax treatment of qualified plans, then we can, as he suggests, dispense with the many Internal Revenue Code provisions designed to ensure that such plans conform and contrib-

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1. *See, e.g.*, Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851 (1987); Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration and the Quest for Worker Security*, 42 TAX L. REV. 433 (1987); Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419 (1984); Oberst, *A Perspective of the Qualified Plan Tax Subsidy*, 32 BUFF. L. REV. 603 (1983).

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

3. *Id.* at 316. For an earlier lawyerly argument that the tax treatment of qualified plans should not be regarded as giving rise to tax expenditures, see Frie & Archer, *Taxation and Regulation of Pension Plans Under the Internal Revenue Code*, 1967 U. ILL. L.F. 691, 697-99 (1967).

ute to our national retirement policy.[4]

Professor Zelinsky's argument is that the current manner of taxing qualified plans—an immediate deduction for the employer, tax-free accumulation of earnings, and no income to employees until receipt—is preferable[5] to any alternative tax scheme yet suggested when evaluated from the criteria of measurability, administrability, acceptability, liquidity, simplicity, and equity. In Professor Zelinsky's words,

> Suppose . . . that Congress is not interested in encouraging [retirement] plans, but only seeks a normatively correct tax treatment. This Article concludes that, under these circumstances, considering such criteria as liquidity, measurability, and the like, Congress could plausibly decide on the essentials of current law—employer deductions at the time contributions are made, taxation of employees on actual distribution, and tax-free accumulation of income in between—as a normative matter.[6]

Professor Zelinsky does not argue that our current tax rules are neutral with respect to the choice between immediate and deferred compensation—if he did, he would be wrong[7]—but that his collective criteria are more important considerations than achieving tax neutrality between deferred and immediate compensation.[8]

I disagree with Professor Zelinsky. A tax system should not, except by design and for good reason, tax some types of income at lower effective tax rates than other types of income. Moreover, taxing retirement income at a reduced rate of tax reduces the degree of both horizontal and vertical equity in our system: horizontal equity because employees who participate in retirement plans are taxed at lower effective rates than employees who instead receive

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4. Zelinsky, *supra* note 2, at 316-17, 346.

5. Professor Zelinsky states that current law "is as attractive as . . . [alternative tax regimes], superior to some of [the alternatives], and consequently an appropriate part of a normative income tax." Zelinsky, *supra* note 2, at 316. The entire thrust of Professor Zelinsky's argument, however, is that current law is superior to all alternative regimes. In fact, Professor Zelinsky does not identify any regimes that he finds as attractive as current law.

6. *Id.* at 316.

7. *See infra*, part II.

8. Professor Zelinsky rejects tax neutrality as a criterion because "If existing law fits into a normative income tax . . . these considerations raise a different question: Do we want an income tax." Zelinsky, *supra* note 2, at 334. But this statement does not bear up under analysis: an alternative tax regime should come closer to achieving neutrality than current law if it increases the effective tax rate on pension savings to any level equal to or lower than the effective tax rate on immediate compensation. *See infra* text accompanying notes 86-88.

immediate cash compensation; vertical equity both because participants in such plans tend to be relatively better off economically than nonparticipants[9] and because the amount of benefit accruing to participants depends on their marginal tax rates. This Article will argue that Professor Zelinsky shortchanges these concerns and that we should be willing to tolerate some deficiencies (in terms of Professor Zelinsky's criteria) in a tax regime in exchange for greater neutrality between deferred and current compensation than we now have, unless we wish to use tax subsidies to encourage the formation of retirement plans that advance retirement policy goals and can design the law to do so.[10]

Initially, however, I will accept Professor Zelinsky's approach to defining a normative tax but argue that there *are* alternative tax regimes that adequately satisfy his criteria without subsidizing retirement savings. This Article proposes one such alternative: treating the funds in retirement plans as a bookkeeping reserve of the employer. Such an approach would tax pension contributions and earnings to the employer during the period in which the employee's compensation is deferred. The employer would receive a deduction, and the employees would recognize income, only as the plan pays benefits.

This is, in fact, the way our tax system already treats unfunded deferred compensation arrangements.[11] In defending under Professor Zelinsky's criteria this same approach for funded arrangements, this Article suggests that Professor Zelinsky's probable objections would be based on (1) transition problems that would arise if current tax rules were replaced with new rules, which are not appropriately considered in assessing under Professor Zelinsky's criteria whether current rules give rise to tax expenditures;[12] (2) a skepticism that the labor markets will efficiently allocate the incidence of tax on accumulating pension assets;[13] (3) an

9. *See infra* text accompanying notes 21-23.

10. *See National Pension Policies: Private Pension Plans: Hearings Before the Subcomm. on Retirement Income and Employment of the House Select Comm. on Aging*, 95th Cong., 2d Sess., 228-229 (1978) (statement of Daniel I. Halperin, Tax Legislative Counsel, Office of Assistant Secretary of Treasury for Tax Policy)("[S]pecial tax treatment [of qualified plans] . . . can be justified only as a means of furthering . . . goals of social policy"). A question not addressed by this Article is whether the cost/benefit ratio of the taxes foregone compared to the benefits obtained justify the current treatment of qualified retirement plans.

11. *See* Rev. Rul. 60-31, 1960-1 C.B. 174.

12. *See infra* text accompanying notes 37 and 45.

13. *See infra* text accompanying notes 53-58.

assumption that in a world without tax a substantial number of employees would prefer deferred compensation in a defined benefit format over current compensation;[14] and (4) the same social policy considerations that form the basis of the rules for qualified plans that he would slate for elimination.[15]

This Article also argues that Professor Zelinsky's methodology is at bottom based on an unstated and thus undefended assumption that it is desirable for the tax system to develop special rules to accommodate the desire of employers or employees to establish retirement plans. The reader may share this assumption, but if so it is because the reader judges on policy grounds that the government should use the tax system to encourage retirement savings plans. Congress has, in fact, reached just such a judgment and thus has made qualified retirement plans the beneficiaries of favorable tax rules. Congressional munificence has long been conditioned on plans conforming to rules that advance perceived retirement income security goals. Professor Zelinsky's argument ultimately reflects his view that the tax system should encourage virtually all retirement plans.

This reply Article is organized into five parts. The first part shows that our current tax system subsidizes retirement savings with rules resulting in low effective tax rates. This part also shows how this subsidy detracts from the degrees of horizontal and vertical equity built into our system. The second part describes the Article's proposed alternative tax regime. The third part evaluates the proposed regime in terms of Professor Zelinsky's criteria. The fourth part considers the unique circumstances of multiemployer plans, which are collectively bargained plans to which several employers contribute. Finally, the Article suggests problems with Professor Zelinsky's approach to tax expenditure analysis.

B. DIFFERENCE BETWEEN DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS

A final introductory note: this Article is principally concerned with the taxation of defined benefit rather than defined contribution plans. The difference between the two types of plans can be summarized as follows.

A defined contribution plan is a plan in which the employer

14. *See infra* text accompanying notes 64-68.
15. *See infra* text accompanying note 46.

promises to make contributions to a trust or other funding vehicle, which are then allocated to accounts for the participating employees.[16] The funds are then invested on behalf of those employees, with interest allocated on a pro rata basis to each employee's account. At retirement, an employee's accumulated funds are distributed, either in a lump sum or as a series of payments spread over time.[17]

A defined benefit plan, on the other hand, promises to pay participating employees a specified benefit at retirement.[18] The employer's contributions are not allocated among the participants, but rather fund on an ongoing basis the benefits promised by the employer. Employers hire actuaries to determine how much the employer should contribute in a given year to ensure adequate funding of the promised benefit. When an employee retires, the plan either pays the employee the promised benefits from its accumulated assets or uses those assets to purchase a commitment from an insurance company to pay the benefits.

Professor Zelinsky's argument that there are no acceptable alternatives to current tax treatment of retirement plan savings has little applicability to defined contribution plans. It would be possible in a defined contribution plan to tax the employee in each year on the increase in the vested value of his account in the same manner that an investor is taxed on income generated by mutual funds. Indeed, Professor Zelinsky's primary argument for retaining current tax treatment of defined contribution plans is that "the tax consequences of qualified plan participation should not depend on an employer's decision to use one type of arrangement rather than another."[19] This Article thus assumes that taxation of defined contribution plans does not present formidable theoretical or practical problems in and of itself.

II. Tax Deferral and Its Consequences Under Our Current Tax Regime

The deferral of tax on retirement plan income under our present tax rules reduces the effective tax rate on retirement savings. For example, assume two employees, each of whom is subject to a 33 percent marginal tax rate. One employee receives $1,000 in cash

16. *See* I.R.C. § 414(i) (1988); *see also* Rev. Rul. 80-155, 1980-1 C.B. 84.
17. *See* G. Boren, Qualified Deferred Compensation Plans §§ 1:08-1:10 (1989).
18. *See id.* at § 1:07.
19. *See* Zelinsky, *supra* note 2, at 363.

compensation, the other employee receives a $1,000 contribution to a qualified retirement plan.

Assume the employee who receives cash pays his tax ($330) and wishes to invest the balance ($670) in order to save for retirement, which will be 30 years hence. He thus places the balance in a taxable savings account that pays 10 percent annually compounded interest. After tax the account grows at 6.7 percent and at the end of 30 years the employee will accumulate $4,688 in savings. In contrast, the $1,000 contribution made to the second employee's retirement plan is not reduced by tax. Assuming the contribution earns a 10 percent rate of return, the employee's interest in the plan grows to $17,449 after 30 years, which the plan then distributes to her. After paying tax at a 33 percent rate, the employee still has $11,691, or 2.5 times more than the first employee. The effective annual tax rate for the second employee has been reduced from 33 percent to 10.5 percent.[20]

The above illustration suggests that employees who wish to minimize tax will prefer deferred to immediate compensation. This preference obviously skews the overall rate of deferred compensation in the labor market over what the rate would be under a tax system that displayed neutrality toward the choice between immediate and deferred compensation. The illustration also demonstrates that employees who receive contributions to a deferred compensation plan pay less tax than those who receive an equivalent amount of immediate compensation, thus detracting from the system's horizontal equity.

Current tax treatment also detracts from the degree of vertical

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20. If the taxpayer received $1,000, paid tax on the contribution and subsequent investment earnings at a 10.5 percent rate, the taxpayer in 30 years would have accumulated $11,700. The tax benefit would be further enhanced with either higher marginal tax rates during the period of accumulation, lower marginal tax rates during retirement, or higher rates of return on investment. The converse is also true: the tax benefit would be reduced with either lower marginal tax rates during the period of accumulation, higher marginal tax rates during retirement, or lower rates of return. Moreover, the tax benefits would also be lower for employees who have an opportunity to invest in alternative tax-favored investment vehicles, but only to the extent the market does not increase the price of such investment vehicles to reflect their tax-favored status, *see, e.g.*, R. GOODE, THE INDIVIDUAL INCOME TAX (1976).

The Internal Revenue Code provides additional tax benefits to pension plan participants. First, a retiree can further defer tax on her benefits either by taking an annuity rather than a lump sum payment or by "rolling over" a lump sum payment into an individual retirement account. *See* I.R.C. § 402(a)(5) (1988). Second, an employee who receives a lump sum payment may elect special averaging rules that will in some cases further reduce his tax rate on the distribution. *See* I.R.C. § 402(e)(1) (1988).

equity in our system, for three reasons. First, the probability that an employer will defer an employee's compensation (and thereby reduce the employee's effective tax rate on compensation income) is significantly higher for affluent employees than for other employees. A comparison of plan participation by wage and salary income based on a 1983 employee population, showed that over 70 percent of employees earning at least $20,000 annually participated in pension plans, while only 28.9 percent of those earning between $5,000 and $10,000 participated and only 8.8 percent of those earning under $5,000 participated.[21] Second, the dollar amounts contributed on behalf of upper income participants is often a higher percentage of their compensation than is true for other employees.[22] Third, the extent of the economic benefit of tax deferral correlates positively to the employee's marginal tax rate.

This latter point can be illustrated by redoing our example with employees whose marginal tax rate is 15 rather than 33 percent. After 30 years, an employee who receives $1,000 in cash compensation and invests it on an after-tax basis, will have accumulated $9,825 in his savings account. The employee who receives a $1,000 contribution to a qualified plan, on the other hand, will again have a plan accumulation of $17,449, which will be reduced to $14,832 after the employee pays a 15 percent tax. This is only 1.5 times as great as the amount saved outside the plan, compared to the 2.5 ratio for the higher-rate employees in the first example. The actual dollar subsidy of the two plan participants is approximately $7,000 for the employee with a 33 percent marginal rate, but only $5,000 for the employee with a 15 percent rate.[23]

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21. Levontin & Schmitt, *Tax Incentives for Retirement—The Question of Equity*, in PRIVATE SECTOR RETIREMENT AND U.S. TAX POLICY (Government Research Corp. 1984). A Congressional Budget Office tabulation showed that between 71% and 86% of employees earning in excess of $35,000 participated in qualified retirement plans, while only 24% to 34% of employees earning less than $10,000 participated. CONGRESSIONAL BUDGET OFFICE, TAX POLICY FOR PENSIONS AND OTHER RETIREMENT SAVING 46 (Table 8)(1983). The statistics were compiled by age group, with the low end of the two ranges reflecting employees between ages 25 and 34, the high end employees between ages 45 and 64. *See also*, A. MUNNELL, THE ECONOMICS OF PRIVATE PENSIONS 45-46 (1982).

22. The Code permits pension plans to "integrate" with social security. I.R.C. § 401(l). Plan integration means that a plan may provide a benefit based on a higher percentage of compensation in excess of the social security contribution base than it provides with respect to compensation up to the contribution base. *See* G.BOREN, *supra* note 17, Ch. 6 for a probing critique of the integration concept. *See also* Altman, *supra* note 1, at 478-98. In 1990, the social security wage base was $51,300. 9 Fed. Taxes(P-H) ¶ 35,014.07.

23. The difference would have been more dramatic under the pre-1986 tax rate schedule, under which marginal tax rates varied from 12 to 50 percent. I.R.C. § 1(a)-(d) (1985).

III. Description of Hypothetical Tax Regime

In the early days of our income tax law, the Bureau of Internal Revenue was concerned with the increasing employer practice of deducting contributions to revocable employer-controlled pension funds. The Bureau, in litigation, took the position that an employer could not deduct pension plan contributions unless the pension funds were irrevocable trusts beyond the employer's control.[24] An employer who failed to establish an irrevocable trust would, under this view, receive no deduction for contributions made to its pension reserve, would pay tax on the interest earned by the accumulating reserves, and would receive deductions as benefits were actually paid, at which point the employee would be taxed on the benefits received.[25]

The courts disagreed with the Bureau's position, and ultimately the Bureau conceded the issue.[26] Nonetheless, the system just described—taxing earnings set aside for pension benefits to the employer at the employer's tax rates—is a plausible means of taxing defined benefit plan assets, and is in fact the manner in which our current tax system treats unfunded deferred compensation plans.[27] The system can also work even where assets are held in trust. Of course if trust earnings were being taxed to the employer, the law could, and probably should, permit the tax attributable to those assets to be paid from the trust's assets rather than directly by the employer.

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24. *See* Hibbard, Spencer, Bartlett & Co. v. Comm'r, 5 B.T.A. 464 (1926) (Bureau challenged deduction for contribution to a revocable pension fund not properly created as trust), *acq.*, VIII-2 C.B. 23 (1929); Livestock Nat'l Bank v. Comm'r, 7 B.T.A. 413, *acq.* VI-2 C.B. 4 (1927) (Bureau challenged deduction for contribution to pension trust); Elgin Nat'l Watch Co. v. Comm'r, 17 B.T.A. 339 (1929) (Bureau challenged contribution to a pension trust permitting reversions), *acq.* X-2 C.B. 21 (1932) (pension trusts are separate taxable entities), nonacq. X-2 C.B. 21 (1932) (other issues).

25. In effect, the pension plan's funding vehicle would be a bookkeeping reserve on the employer's books.

26. After acquiescing in cases litigated before the Board of Tax Appeals, *see* note 24, *supra*, the Bureau promulgated new regulations permitting an employer to deduct contributions to a pension trust, even though revocable, provided that the "trust is of such a character as to evidence good faith on the part of the employer actually to pay the amounts placed in trust for employees' pension purposes." Treas. Reg. § 23¶-1(b), T.D. 4792, 1938-1 C.B. 152.

27. Rev. Rul. 60-31, 1960-1 C.B. 174. *Cf.* I.R.C. §§ 419, 512(a)(3) (tax treatment of funded welfare benefit plans). In this Article's suggested regime, the plan income that would be subject to tax at the employer level would be the *plan's* investment income; the corporation's dividend received deduction would thus be unavailable for dividend income paid to the trust. Special rules also might be appropriate to limit deduction of business operating losses against plan portfolio income.

Because under our present law pension plan assets accumulate free of taxation, changing the law to impose current taxation of pension contributions and earnings at the employer's tax rate would increase the employer's cost of providing benefits. Employers could react by maintaining current levels of benefits and increasing contributions; maintaining current levels of contributions and reducing benefits; or by combining a contribution increase with a benefit reduction.

The tax regime suggested above would not result in taxing retirement plan savings entirely at the employer's tax rates. When a plan paid benefits the employer would receive a deduction whose value reflected the expenditure multiplied by the employer's marginal tax rate. The deduction thereby permits the plan to pay grossed-up benefits reflecting the tax savings to the employer at the time of benefit payment.[28]

Assume, for example, an employer with a 34 percent marginal tax rate, the maximum corporate rate.[29] Further assume a 10 percent before-tax rate of return and a 30-year period between the plan contribution and benefit payment. The employer contributes $1,000 to the plan, leaving the plan with $660 after paying tax. The $660 will grow to $4,490 in 30 years, at which time the employer will pay and deduct benefits to the employee. Taking into account the value of the deduction to the employer, the employer should be willing to pay the employee $6,803 in benefits, because the after-tax cost of this payment is $4,490. The employee would then pay tax on the distribution at the employee's marginal rate. If the employee's rate were 28 percent, the employee would have $4,998 after tax; if the employee's rate were 15 percent, the employee would have $5,783 after tax.

IV. Hypothetical Tax Regime Considered Under Professor Zelinsky's Criteria

A. *MEASURABILITY*

The first of Professor Zelinsky's categories is measurability, *i.e.*, the ability to calculate with reasonable accuracy the taxpayer's income.[30] There is no difficulty in measuring income, either theo-

28. *Cf.* Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506, 521-23 (1986).

29. I.R.C. § 11(b)(1)(C) (1988).

30. *See* Zelinsky, *supra* note 2, at 327.

retical or practical, under this Article's proposed regime: the income being measured in each year is the employer's earnings set aside to pay pension benefits, including interest derived from the accumulated assets held by the pension plan.

B. ADMINISTRABILITY

A system that taxes the employer on pension earnings and allows the employer to deduct benefit payments poses no insoluble administrability problems.[31]

C. LIQUIDITY

The basis for Professor Zelinsky's liquidity criteria is that "a law which taxes when the taxpayer has cash is preferable to one which taxes when he does not."[32] From the perspective of the employee, this Article's proposed regime would not alter the status quo, for the employee's tax liability would still be tied to the time of benefit payment. Professor Zelinsky argues that the employer also faces liquidity issues.[33]

On first consideration, it would seem that the employer should not encounter liquidity issues because the proposed regime requires the employer to use plan assets to pay tax only on the actual income that the plan earns during the relevant year. But Professor Zelinsky would regard this analysis as incomplete, for the employer would not receive deductions for contributions to a pension plan until the plan distributed benefits.[34] Thus, an employer that maintained a plan promising a particular level of benefits would not only have to make a contribution to the retirement plan sufficient to fund the promised benefits, but would also have to pay tax on its contribution; the employer might lack sufficient liquidity both to make the contribution and to pay the tax.[35]

Similarly, an employer would have to pay current tax on retirement plan earnings, thereby reducing the effective rate of return from a pre-tax to an after-tax level. As a result, an employer that wished to keep benefit levels intact would need to increase the level of plan contributions in order to account for the lower effec-

31. *Id.* at 329-30.
32. *Id.* at 330.
33. *Id.* at 359-60.
34. *Id.*
35. *Id.* Professor Zelinsky raises this issue in a discussion of delaying employers' deductions until employees receive their benefits.

tive investment yield, creating further liquidity problems.

The employer could avoid liquidity problems by reducing plan benefits to the level where their after-tax cost equals the cost of providing current benefit levels. Professor Zelinsky, however, dismisses the possibility of benefit reductions, finding them inapplicable to employers constrained by bargaining or market forces.[36]

Market or labor constraints may in the short term prevent some employers from reducing benefits, necessitating increased contributions and, for some employers, creating liquidity problems. The problems, however, would not be attributable to the tax rules proposed by this Article, but rather by the transition to them from current law.

Transition problems are relevant in assessing whether it makes sense to change current tax laws. Professor Zelinsky, though, does not argue that we should forego alternative tax rules because of serious transition issues, but that we should forego alternative tax rules because they are normatively inferior to current tax rules. Or, phrased differently, we should forego alternative rules because current rules would represent a plausible choice for Congress in "a world in which no choices have [yet] been made as to the income tax treatment of qualified plans."[37]

By identifying transition problems rather than defects inherent in alternatives to current rules, Professor Zelinsky abandons the argument he sets out to make, *i.e.*, current tax rules are normatively correct, in favor of a different argument, *i.e.*, we should retain current tax rules because a transition to theoretically better rules would be too painful. The difference between the arguments may appear subtle, but the practical gulf between their consequences is wide, for only the former argument supports the view

36. *Id.* at 360.

37. *Id.* at 316. It could be argued that the transition issue would have existed at the outset of the income tax, to the extent funded defined benefit plans existed, and thus would have been a factor that Congress could have considered in designing an appropriate normative structure for the income tax treatment of such plans. This argument, however, is not without problems. The imposition of an income tax affects all income and thus has transition costs across the board. There is nothing unique about income earned by or contributed to defined benefit pension plans that would justify exempting it from such across-the-board transition effects.

The argument also has a historical difficulty: there were few defined benefit plans on a prefunded basis when the income tax was enacted. M.LATIMER, INDUSTRIAL PENSION SYSTEMS 572 (1932) (as of 1928, more than a decade after the income tax became effective, only one of six plans was either adequately funded or had plans to become so). Congress did not need to worry about rules for such plans because few adequately funded defined benefit plans existed at the dawn of the income tax.

that we do not need to justify current law on the basis of retirement security policy.

D. *ACCEPTABILITY*

Professor Zelinsky observes that a tax system, particularly one that relies heavily on voluntary compliance, should be acceptable to taxpayers.[38] Taxpayers accept current treatment of qualified plans because it comports with our collective instinct that income should be taxed on receipt and not before.[39] This Article's proposed regime would not tax the employee, the employer, or the retirement plan trust before receipt. Thus, the proposed alternative regime should not pose an acceptability problem of the kind just described.

A change from current tax rules to this Article's alternative might create a different acceptability problem. Such a change would cause some employers with existing plans to reduce benefits or do away with plans in order to avoid increased contributions. Many taxpayers would regard with alarm tax law changes that produce such a result, just as many taxpayers would regard with alarm any change in tax rules that decreased their wealth, even though indirectly. It is difficult to take this argument too seriously, however, for a similar argument can be made on behalf of preserving virtually any existing tax benefit. Moreover, this type of acceptability issue reflects transition issues: employers would be forced to reduce benefits only because of a move from the current regime in which employee plans are tax-favored to a regime in which they are not.

Professor Zelinsky proposes deleting many policy oriented tax law requirements, including requirements that force pension plans to cover rank-and-file employees. One can expect that some employers would react to such a change in the tax laws by dropping many rank-and-file employees from their plans; this, too, might raise acceptability problems from the perspective of the former participants.

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38. Zelinsky, *supra* note 2, at 331.
39. *Id.*

E. SIMPLICITY

Professor Zelinsky observes that simplicity is a virtue in a tax system,[40] which is certainly a truth, even if honored largely in the breach. The current system, with all its complex requirements for retirement plans, is not, as Professor Zelinsky observes, simple at all. The current tax regime, then, would appear to fail under Professor Zelinsky's simplicity criterion. Professor Zelinsky, however, proposes to disengage the tax deferral rules under current law from the complex plan qualification requirements on which the deferral is conditioned. As Professor Zelinsky explains:

> If present law is itself normatively correct, however, the complexity of current law is unnecessary. Congress need not control, on tax expenditure grounds, that which is not a tax expenditure. Thus, the complexity of current law is not an inevitable extension of the present treatment of qualified plans, but largely reflects the erroneous presumption that existing law is a tax expenditure which must be channelled through an elaborate statutory mechanism. Liberated from the label of tax expenditure, the essentials of the current treatment of qualified plans could be implemented through a simpler statute than the suggested alternatives.[41]

Thus, Professor Zelinsky would achieve simplicity by retaining the tax deferral norm and abandoning the qualification conditions.

The alternative rules proposed by this Article also could dispense with qualification requirements. Moreover, in some respects the rules required by this Article's proposed regime could be even simpler than those that would apply under Professor Zelinsky's blueprint for simplification, for Professor Zelinsky apparently would retain the Code sections that limit the amount of income that an employer can defer for its employees through a qualified plan.[42] Without such limits, retirement plans would allow affluent taxpayers to defer tax on unlimited amounts of savings by transferring their savings to a retirement plan, effectively transforming our taxing system from a tax on income to a tax on consumption.

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40. *Id.* at 332-33.

41. *Id.* at 333.

42. Section 415(c) limits employer additions to an employee's account in a defined contribution plan to the lesser of 25% of the employee's compensation or $30,000 (indexed); section 415(b) limits the benefit that can be paid (or funded) in a defined benefit plan to an annual annuity equal to the lesser of $90,000 (indexed) or 100% of compensation; and section 415(e) limits the combined additions and benefits in cases where an employer maintains both defined contribution and defined benefit plans. In addition, section 404 limits the amount an employer can deduct for contributions to qualified plans.

Professor Zelinsky's article implicitly recognizes the need for such limitations and does not propose their abandonment.[43]

The limitations, however, could be abandoned if the tax regime proposed by this Article were adopted, for the regime would tax retirement plan income as it was earned. Thus, the Article's proposed rules could dispense with the aforementioned limitations, which are among the most complex of all the rules applicable to qualified plans.[44]

F. EQUITY

1. Professor Zelinsky's Equity Objections

Professor Zelinsky's article suggests that he would object to this Article's proposed alternative to current law on three equity-based grounds. The first ground is that high-income employees might be able to shift a disproportionate share of any benefit reductions caused by a change in current law to rank-and-file employees. Such a result would be unfair to rank-and-file employees, who would be forced to accept reduced pay in order to minimize benefit reductions for more affluent taxpayers.

Professor Zelinksy's concern here, however, is premised on a transition problem, *i.e.*, how employers would charge particular groups of employees for the increased cost of benefits under new tax rules. As this Article has already suggested, transition problems do not support Professor Zelinsky's view that our current rules are normatively superior to available alternatives.[45] Moreover, assuming an efficient labor market, time should ameliorate the problem to the extent it arises.

Interestingly, Professor Zelinsky's concern here is premised on social policy considerations relied upon by adherents of a tax ex-

43. The issue of whether the limits on deductions, contributions, and benefits are justified is not directly addressed by Professor Zelinsky. The limitations, however, are conspicuously absent from Professor Zelinsky's list of Code provisions that might be eliminated. *See* Zelinsky, *supra* note 2, at 332-33 ("if the status quo is only justified on the basis of national retirement policy, the elaborate structure of vesting, coverage, nondiscrimination, and participation rules is necessary . . .").

44. Eliminating the limitations, however, would create possibilities for taxpayers to engage in rate arbitrage with tax-exempt and low-marginal tax rate employers, which is a problem that already exists with respect to some nonqualified plans. This issue is discussed *infra* at text accompanying note 60. Taking steps to limit the possibilities of rate arbitrage would restore at least some of the complexity of the section 415 limitations, but with respect to a smaller universe of plans than is now the case.

45. *See supra* text accompanying note 37.

penditure view of qualified plans to justify their favorable tax treatment: that tax rules should protect the benefits of rank-and-file employees. However, Professor Zelinsky's own simplification proposals—justified on the grounds that current law does not require a tax expenditure rationale—would harm rank-and-file employees too, because some of them would be dropped from plan coverage as a result of eliminating current plan coverage requirements.[46] Professor Zelinsky, then, rests his argument on contradictory grounds: 1) The tax system should not affect the social welfare goal of protecting the interests of rank-and-file employees in pension plans because the system's treatment of pension plans does not generate tax expenditures; 2) One of the reasons the tax treatment of pension plans does not generate tax expenditures is that any alternative regime might harm rank-and-file employees.

Professor Zelinsky's second objection to this Article's proposed regime would be that given current tax rates, it would overtax, and thus penalize, *employees* whose compensation is deferred.[47] To illustrate, return to the earlier hypothetical comparing the employee who receives and invests $1,000 in immediate compensation and the employee who receives a $1,000 contribution to a deferred compensation plan. Assume a 15 percent marginal tax rate for the employee, a 34 percent marginal tax rate for the employer, a 10 percent before-tax return, and a 30-year period of accumulation. The $1,000 paid directly to the employee will grow to $9,825. The $1,000 that is deferred will grow in value, ultimately allowing the employer to pay the employee $6,803 at the end of 30 years. After the employee pays tax, he will have only $5,783. The employee who receives cash is thus approximately 1.8 times better off than the employee who receives deferred compensation.

Professor Zelinsky would argue that this example demonstrates that the Article's proposed alternative to current law would impose a punitive tax on the employee, thereby violating equity norms. This is not necessarily correct, however, for Professor Zelinsky does not demonstrate that it will be the employee who will *actually* pay the excess tax that results because the employer pays deferred rather than immediate compensation. It is, in fact, plausi-

46. *See* I.R.C. § 410(b) (1988), which Professor Zelinsky would slate for deletion. Zelinsky, *supra* note 2, at 332-33.

47. Zelinsky, *supra* note 2, at 358. This point is made in a discussion on the feasibility of imposing a flat tax on the earnings of pension plans. See *infra* text accompanying notes 84-85 for a discussion of a flat tax imposed on plan earnings.

ble that the employer will bear much of the incidence of the excess tax.

In reflecting on whom the incidence of the tax will rest, consider two situations: first, when the employer's preference for deferred compensation is stronger than the employees'; and second, when the employees' preference is stronger than the employer's.

Situation One: Stronger employer preference for deferred compensation

Employers might choose to defer employee compensation to effect management strategies. Defined benefit plans can reduce employee turnover by conditioning the right to receive benefits on satisfaction of service requirements.[48] Reduced employee turnover results in reduced recruitment and training costs. Deferred compensation plans can also encourage superannuation of employees whose productivity has declined because of age.[49] This can be especially important to some employers given the illegality under the Age Discrimination in Employment Act of 1967[50] of compelling employees to retire because they reach a certain age. Finally, deferred compensation plans may give the employer control of a large pool of capital in the period between plan contribution and benefit payment.[51]

There may be situations, then, in which employers would desire to defer part of their payroll costs even absent current tax treatment and in the face of employee indifference. Professor Zelinsky assumes that such employers would be able to pass the incidence of the excess tax on deferred compensation to the employees by forcing the employees to accept less in total wages. This assumption rests on a skepticism about the efficiency of the markets for labor.

In a market for labor, wages are determined by the coincidence of the supply and demand curve.[52] The supply curve should

48. *See* J. LANGBEIN & B. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 28-29 (1989).

49. *Id.* at 30; *see generally*, M. Morrison, *Changes in the Legal Mandatory Retirement Age: Labor Force Participation Implications*, in ISSUES IN CONTEMPORARY RETIREMENT (R. Ricardo-Cambel & E. Lazear eds. 1988); L. Kotlikoff & D. Wise, *The Incentive Effect of Private Pension Plans*, in ISSUES IN PENSION ECONOMICS (Z. Bodie, J. Shoven & D. Wise, eds. 1987).

50. 29 U.S.C. §§ 621-634 (1985).

51. In *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir. 1982), for example, corporate management used plan assets to fight a takeover bid.

52. P. SAMUELSON & W. NORDHAUS, ECONOMICS (12th ed. 1985) 613-23; *see generally*, Ippolito, *The Labor Contract and True Economic Pension Liabilities*, 75 AM. ECON. REV. 1031 (1985).

represent the dollar values *employees* put on particular wage offers. Because most wage offers include both cash compensation and benefits, employees, in order to value competing offers, must reduce benefits to a cash equivalent, at least in an approximate way.[53] The cash value an employee places on a benefit—the amount of cash the employee would exchange the benefit for—will depend on the value the employee places on the benefit rather than on the benefit's after-tax cost to the employer.

Consider these observations in the context of deferred compensation. An employee who is indifferent to the choice between deferred and immediate compensation should demand that the after-tax future value of deferred compensation equal the after-tax future value of immediate compensation.[54] If the employer insisted on paying less in deferred compensation, we would expect the employee to change to an employer who offers the $1,000 in immediate compensation or makes a promise to pay deferred compensation equal to the future value of that immediate compensation.

The accuracy of the predicted results under the model described above assumes that employees have the financial sophistication and information to value promises of deferred compensation, and the existence of a labor market in which different employers offer wage packages containing different mixes of deferred and immediate compensation.[55] This is likely to be true only in an approximate way. Moreover, the model assumes an inelastic demand curve and ignores many factors that might bear on the amount of deferred compensation that a participant will accept in lieu of immediate compensation.[56]

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53. Ippolito, *supra* note 52, at 1032 ("I begin by making the assumptions that firms do not provide pensions to workers for free, and that workers will not sacrifice wages in excess of the true value of the pension. Workers pay firms an amount that is precisely equal to the present value of expected pension payments.").

54. An employee who received $1000 in cash compensation was able to invest $850 after tax, which grew at an 8.5% after-tax return to $9825 in 30 years. An employee who is indifferent to the choice between deferred and immediate compensation and who is confident in the stability of the 15% tax rate and the 8.5% rate of return should be willing to accept deferred compensation in lieu of $1000 as long as the deferred compensation plan will pay at least $9825 in not more than 30 years. The employee should not be willing to accept a reduced amount simply because the employer's cost of paying deferred compensation is higher than the employer's cost of paying immediate compensation.

55. An employer that offers a defined contribution plan would be able to provide deferred compensation that is taxable at the employee's tax rate and thus avoid the excess tax resulting from taxing the deferred compensation at the employer's marginal tax rates. *See, infra*, notes 69-73, and accompanying text.

56. It should be noted that some employees will favor immediate compensation be-

Nevertheless, empirical research suggests that employees do value deferred compensation promises and are willing to accept reduction in cash wages on account of them.[57] And it seems a fair assumption that employees, in determining how much of a reduction in cash wages to accept in exchange for a given level of benefit, will not factor into their consideration the fact that accumulating pension assets will be taxed at their employer's marginal tax rates rather than at their own lower rates. Thus, while a labor market model may not yield a complete explanation of where the incidence of the higher tax cost on deferred compensation will fall, it does suggest that employers will bear much of the burden.

If the employer will bear at least a share of the excess tax-driven cost of deferred over immediate compensation, another issue arises: whether it is troubling, from an equity perspective, that the employer's cost of deferred compensation exceeds the employer's cost of immediate compensation? In one sense, it is not, for the employer's increased cost purchases not only compensation, but also reduced turnover and more efficient superannuation. The employer, not the employees, should bear these costs.

This is, of course, true as between the employer—who benefits from the reduced turnover and efficient superannuation—and the employee, but it does not explain why the tax system should burden the employer who pays deferred compensation with higher payroll costs than the employer who pays immediate compensation? Why then, as Professor Zelinsky almost certainly would argue, do these higher payroll costs, tax-driven as they are, not violate equity norms?

The first reason is that current tax law presents the mirror

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cause of the choices it gives them between consumption and saving. *See infra* text accompanying note 63. Under the model, such employees would not accept deferred compensation unless the present value of the compensation reflected their preference for immediate compensation.

57. There have been at least two studies that suggest that employers which offer high pensions are able to pay lower wages. Schiller & Weiss, *Pensions and Wages: A Test for Equalizing Differences*, REV. OF ECON. & STAT. 529 (1980); Ehrenberg & Smith, *The Wage/Pension Tradeoff*, *in* PRESIDENT'S COMMISSION ON PENSION POLICY, COMING OF AGE 1200 (1981). There has been more extensive research on the pension/wage mix in the public sector, and these studies also suggest that there is a tradeoff between cash compensation and the value of a pension plan. *See, e.g.*, Ehrenberg, *Retirement System Characteristics and Compensating Wage Differentials in the Public Sector*, 33 INDUS. & LAB. REL. REV. 470 (1980); Smith, *Compensating Differentials for Pensions and Underfunding in the Public Sector*, 63 REV. OF ECON. & STAT. 463 (1981); Vroman, *Employer Payroll Tax Incidences: Empirical Tests With Cross-Country Data*, 29 PUB. FIN. 184 (1974); Brittain, *The Incidence of Social Security Payroll Taxes*, 61 AM. ECON. REV. 110 (1971).

image of the problem described: it reduces the cost of paying deferred compensation relative to the cost of paying immediate compensation. A set of rules that reduces the employer's cost of providing deferred compensation is no less troubling than one that increases the cost. Moreover, the increase in the cost of providing deferred compensation under this Article's proposed regime is only a subset of a pervasive problem of a tax system with a multiple progressive rate structure: the payor's deferral of payment effectively reduces the total after-tax costs of the transaction as a whole when the payor's marginal tax rate is lower than the payee's. Conversely, deferral of payment increases the transaction's overall after-tax cost when payors have higher tax rates than payees.[58]

These problems of mismatched rates of payor and payee should concern us in the former situation, because they permit taxpayers to manipulate the system in order to reduce the after-tax economic cost of a transaction. Congress has in the past decade begun attending to this problem by legislating rules that attempt to curb a variety of tax abuses based on taxpayer manipulation of the Internal Revenue Code's traditional blindness to the time value of money.[59]

The problems should concern us in the second situation if the parties are not able to protect themselves from the extra tax costs by restructuring the transaction. In the deferred compensation situation, the employer could protect itself from punitive tax rates by structuring its deferred compensation plan to permit employees to be taxed on their vested interest in the plan.[60] As suggested in the next section, one way an employer might so structure a plan is in a defined contribution format, which would permit plan contribution and income to be taxed at employee marginal rates.

Situation Two: Stronger employee preference for deferred compensation

Suppose that the employee rather than the employer wants the employer to defer and invest compensation until retirement. Employees might prefer deferred compensation because they believe the employer can achieve high rates of return.[61] Employees

58. In this case, prepayment will reduce costs. *See* Halperin, *supra* note 28, at 515-19.

59. The original discount rules are an example of Congressional effort to come to grips with the types of problems described in the text. *See* Halperin, *supra*, note 28, at 506-15.

60. The employer could also pay employees immediate cash compensation.

61. *See, e.g.*, W. WENDLING, C. CRABB-VELEX, M. CARLSEN, THE REGULATORY IMPACT OF PENSIONS 21 (1986); J. LANGBEIN & B. WOLK, *supra* note 48, at 30-31.

might also believe that they lack the will to save adequately for retirement unless their compensation structure forces them to save.[62] In such situations, taxing the accumulating pension assets at the employer's higher marginal tax rate *would* overtax the employee. The employees would thus have to choose between nonpunitive tax rates or their favored form of compensation.

The question raised by this potential punitive tax is whether Congress should protect employees who favor deferred compensation from higher tax rates by providing, as our current system does, a reduced rate of effective tax on such compensation. The problem is complicated because the lower tax rate on deferred compensation makes deferral attractive to all tax sensitive employees, even those who in a world without tax would favor immediate compensation. The remedy to the punitive tax, then, creates the problem of providing a tax reward for deferring compensation. This raises the question of whether it is better to grant a tax reward than extract a tax penalty on deferred compensation. Professor Zelinsky would argue the latter, but there is reason to disagree with him.

The demand for deferred compensation without a favorable tax rate may not be large. Intuitively, rational individuals might be expected to choose immediate over deferred compensation because of the choice it offers between consumption and savings. Even taxpayers inclined toward savings might prefer cash compensation, which can be invested in more liquid mediums than an interest in a retirement plan, which substantially restricts access to funds until retirement.[63]

It is difficult to test these points empirically because for the past 70 years the choice given to employees has been to receive immediate compensation or tax-advantaged deferred compensation. There is, however, some evidence that employees who are not sensitive to tax considerations opt for immediate compensation.

Under current law, plans often discharge their obligations to separated employees by paying them a lump sum amount equal to

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62. *See* sources cited *supra* note 61.

63. D. HAMERMESH & A. REES, THE ECONOMICS OF WORK AND PAY 341 (4th ed. 1988). The authors observe that:

> The great advantage of current cash compensation is that it maximizes workers' freedom to spend their income how and when they like and to make such provision for contingencies and risks as they think proper. In contrast, other forms of compensation determine part of their consumption pattern for them and, at worst, may be entirely useless.

the present value of their plan benefits. The law permits employees who receive such lump sum benefits to "rollover" the lump sum to either an individual retirement account or to another qualified plan, thus continuing the deferral of compensation.[64] The vast majority of employees, however, do not roll over the benefits but use them for current consumption.[65] As Professors John Langbein and Bruce Wolk have observed, this study suggests that most employees do not prefer deferred compensation even though it is tax advantaged.[66]

The participation rate for employees in qualified plans by income level also suggests that employees participate in such plans because of their favorable tax treatment. The tax benefits of plan participation depend on a taxpayer's marginal tax rates.[67] Moreover, plan participation rates increase with income levels, suggesting that tax factors heavily influence the decision of employers to offer and employees to take deferred compensation.[68]

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64. I.R.C. § 402(a)(5) (1988).

65. Snyder, *Spend It or Save It?*, SOCIAL SECURITY BULL., Sept. 1986, at 15 (Table 3).

66. J.LANGBEIN & B.WOLK, *supra* note 48, at 93. This raises the issue of why employees who are not sensitive to tax considerations participate in plans set up to benefit employees who are sensitive to tax considerations. A simple, but incomplete, explanation is that federal law requires a plan to cover most employees. See I.R.C. § 410(b). Thus, if an employer sponsors a plan for highly compensated employees, it must also include other employees. This, however, does not completely explain the existence of union negotiated plans, which will not always include highly compensated employees. There are plausible explanations for union plans, however, which may also offer some insight into non-negotiated plans. One explanation is that a significant motivation for union officials to negotiate pension plans is to have a fund whose assets could be used to effect other union goals, or to retain control over members. *See, e.g.*, Blankenship v. Boyle, 329 F.Supp. 1089, 1096-1104 (union deposited substantial plan holdings in noninterest bearing accounts in bank favored by union) (D. D.C 1971); *id.* at 1105-06 (use of plan assets to purchase utility companies for purposes of forcing them to buy union mined coal); Donovan v. Walton, 609 F. Supp. 1221 (S.D. Fla. 1985), *aff'd sub nom.* Brock v. Walton, 794 F.2d 586 (11th Cir. 1986)(fund constructed office building with intent to lease to union; fund also made payments to union for "in kind services.").

Another explanation is that defined benefit pension plans disproportionately benefit older employees who have long service. It is possible to theorize that defined benefit pension plans permit long-service employees to sell their equity interest in the employer to young employees in a way that might not be possible if only cash wages were paid, because of younger employees would object to an explicit transfer. *See* J. BULOW & M. SCHOLES, WHO OWNS THE ASSETS IN A DEFINED BENEFIT PLAN (National Bureau of Economic Research Working Paper No. 924, 1982). However, younger employees may not appreciate fully the disparity in value between their pension accruals and those of older employees, while older employees do understand the difference. Thus, pension plans may provide a cloaking sort of function to disguise the value of wages for older employees.

67. *See supra* text accompanying note 23.

68. *See supra* note 21 and accompanying text. The experience with section 401(k) plans is also instructive. Section 401(k) plans permit employees to choose to have a portion

Moreover, employers could defer compensation in formats that would accommodate taxation at the employees' rates. The obvious vehicle is the defined contribution plan, which would rather painlessly facilitate a tax regime in which employees are taxed on the growth of their vested account balance at their own marginal tax rates.

Some employees might, however, prefer a defined benefit plan format.[69] The question, whether effecting a preference for defined benefit plans over defined contribution plans is sufficient justification for the current tax regime, can be put aside, because it should be possible for employer and employee to negotiate a defined benefit deferred compensation arrangement without a punitive tax. Employers could purchase commercial annuity contracts for such employees, each contract reflecting the benefit accrued during the taxable year; the employee would then be taxed on the premium.[70]

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of their compensation paid into a defined contribution plan. Based on data provided by Employee Benefits Research Institute, the Pension Rights Center, a Washington based advocacy group, has estimated that only 9% of full-time, regular employees with median incomes $25,000 or less choose to participate in such plans, while 32 percent of employees with income in excess of the median do participate. *The Illusory Promises of Retirement Security, Hearings Before the Subcomm. on Retirement Income and Employment of the Select Comm. on Aging*, 102d Cong. 1st Sess. 79, 84 (Comm. Print 1991)(statement of Pension Rights Center). The low participation rates for employees below the median income occurs despite the fact that the section 401(k) discrimination rules encourage employers to offer incentives to nonhighly compensated employees to participate in 401(k) plans. More precise statistics are not presently available, but it is likely that the participation rate in such plans is highest among employees with the highest marginal tax rates.

69. The fact that most collectively bargained plans are defined benefit plans is evidence that the preference for defined benefit plans exists. However, it is difficult to know whether the preference is that of the negotiators or that of the employees. For example, negotiators might prefer defined benefit plans because it permits them to make promises to union members about large future benefits but to defer the pain of funding until later. This was especially the case before ERISA, when there were no adequate funding standards for such plans and the plans were often substantially underfunded. D. GRUBBS, FUNDING at 10 (ALI-ABA Pension & Profit-Sharing Plans, Series D, Folio 1978). Negotiators might also prefer defined benefit plans because those plans gave them access to substantial sums of money; while this might also be true in defined contribution plans, the fact that employees will monitor their account balances forces more accountability in the defined contribution plan format.

70. The Second Circuit held that such contracts were taxable to the employee recipients in United States v. Drescher, 179 F.2d 863 (2d Cir.1950), *cert. denied*, 340 U.S. 821 (1950). The *Drescher* court, however, also held that the employee should not be taxed on the full premium paid by the employer for the annuity contract when the employer did not extend to the employee all rights under the contract. Thus, in *Drescher*, the income to the employee was less than the contract premium because the employer did not permit the employee to exercise an acceleration provision in the contract. *But see Drescher*, 179 F.2d at 867 (Clark, J., dissenting in part) (arguing that employee should be taxed on full premium despite employer's retention of policy because the lack of ability to accelerate did not affect

Employers might also provide defined benefits through a target benefit defined contribution plan,[71] bundled with a contractual guarantee from the employer that the defined contribution account will be adequate to purchase at least a certain level of defined benefit. Under such an arrangement, the employee could be taxed on the employer's contributions to the plan. The problem of how to tax the value of the guarantee is problematic, but there are a number of solutions, none of which is likely to place much stress on revenue collection or tax equity. One approach would be to ignore the value of the guarantee for tax purposes until such time as the employer is required to subsidize a benefit that falls short of the guaranteed minimum.[72] Such arrangements would not replicate all particulars of true defined benefit plans, but they could serve as a means of accommodating much of what some employees might find attractive in defined benefit plans.[73]

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the policy's value).

71. A target benefit plan is a type of defined contribution plan in which the employer initially selects a defined retirement benefit and, using actuarial assumptions that are stated in the plan, determines annual contributions for each employee as if the plan were a defined benefit plan. *See* G.BOREN, *supra* note 17, at § 1:09. These contributions are then paid into a separate defined contribution account for each employee. Target benefit plans differ from true defined benefit plans because retirees receive the value of their accounts, not a promised benefit. Moreover, in target benefit plans, the contributions formulas are not changed—as they are in defined benefit plans—because plan experience diverges from actuarial expectations. Thus, if investment experience is more favorable than the assumptions, the employee will receive a larger benefit than the benefit being "funded"; if experience is less favorable, a smaller benefit.

72. Because the guarantee would run from the employer, and would be backed by the employer's general assets, its value would not be taxed under our ordinary rules of tax accounting until the employer actually made payments to the employee. *See* Rev. Rul. 60-31, 1960-1 C.B. 174. Thus, the taxation of the guarantee could be deferred under today's laws until benefits are actually paid. Fairness and liquidity issues could arise, however, if the employer satisfied the guarantee by contributing a large sum to the employee's account at retirement. The employee might suffer liquidity problems if the employee were taxed on the contribution in the year made. Also, in a tax system with steeply graduated rates, the bunching of income in the year the guarantee was paid to the plan might result in taxing the employee at a higher marginal rate than would have applied if the contributions had been made ratably over the employee's service. These problems, however, could be avoided by either an express ameliorative tax rule or by the employer's structuring the plan to avoid making large payments to an account in a single year. For example, the employee would be taxed only as he received benefits if the employer satisfied its guarantee obligations by supplementing each annuity payment made from the plan with monies from generally operating revenues or from a trust account that is subject to the claims of the employer's creditors in bankruptcy. *See* Priv. Ltr. Rul 8113107 (Dec. 31, 1980) (contribution to nonqualified retirement trust for employee not taxable to employee if trust is subject to creditors of employer in event of bankruptcy proceedings).

73. For example, assume that an employee dies before retirement. In many defined benefit plans, death results in complete or partial forfeiture of benefits, (except for certain

A further equity objection to the Article's proposed regime is that because different employers have different marginal tax rates, the cost of deferring compensation will be greater for some employers than for others. However, this is again only an illustration of a problem of a multi-rate tax system: payors with high marginal rates will have a tax advantage over low-rate payors in any transaction in which there is deferral of payment. Moreover, current law presents a similar problem: employers with a tax sensitive workforce, *i.e.*, employees with high marginal tax rates, will reap a payroll advantage by deferring compensation, for tax sensitive employees will value a dollar contribution to a pension plan more highly than a dollar in immediate compensation (to the extent such employees desire to save). To the extent the employer can force employees to share the tax benefits, the employer will net a payroll savings. A related issue is how to treat plans of tax-exempt employers and employers whose marginal tax rates are low enough to make deferred compensation attractive to certain highly paid employees. Such an employer would, in effect, have the capacity to replicate the favorable details of current law, since it would pay no tax on pension holdings. It may be that special rules would be needed, perhaps the imposition of a minimum flat tax on all pension plan trust earnings (or deemed earnings in the case of a nonfunded plan), forbidding participation in defined benefit plans by employees whose income exceeds a certain level, or some combination of the two.[74]

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required spousel survivor benefits) permitting the amounts contributed on behalf of the employee to be used to pay the benefits of other employees. In effect, this means that the employer's contribution can be discounted for predicted mortality (unless the employer offers a death benefit that offsets the mortality discount). In a target benefit plan, however, it is common for an employee to receive the full value of his or her account on death. Moreover, problems with valuing an employee's plan interest would be greatly complicated if death resulted in forfeiture. *See* Zelinsky, *supra* note 2, at 339. Thus, the employer would not be able to discount for pre-retirement mortality in the type of arrangement suggested here, at least not very easily. This would ultimately effect the employee because the employer would probably react by reducing the size of the promised retirement benefit to compensate for the inability to discount for mortality. On the other hand, the employee would receive a compensating death benefit equal to the size of his or her account in exchange for the reduction in the level of the retirement benefit.

74. Under current law, section 457 imposes limits on the amount of income that an employee can defer under a governmental plan or a plan of a tax-exempt organization. Professor Halperin has suggested that in the context of nonqualified plans in today's world, a solution to the problem of rate arbitrage would be to tax plan earnings at the highest marginal tax rate for individuals. Halperin, *supra* note 28, at 549. To facilitate this approach, Professor Halperin considers requiring a segregated fund for nonqualified plans. Professor Zelinsky objects to Professor Halperin's approach on equity grounds: it would overtax many

2. Other Equity Issues

a. Equality Among Employers

Under present law, an employer may have the choice of funding a portion of benefits in advance of when they accrue, as they accrue, or after they accrue.[75] Because contributions to a pension plan, once made, earn tax-exempt interest, the employer's total after-tax costs are directly tied to the time when the employer contributes to the plan. Thus, the employer who funds in advance of the time benefits accrue will have lower costs than the employer who funds benefits as they accrue, and both will have lower costs than the employer who defers funding until after benefits accrue.

There is no compelling reason to treat employers who front-

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employees. Zelinsky, *supra* note 2, at 358. Professor Halperin's proposal for nonqualified deferred compensation arrangements is similar to this Article's proposed regime; the principal difference being the differing tax rates to which investment income would be subject. I have attempted to defend the use of employer tax rates on normative grounds, but use of a flat tax on trust income based on the individual rate table may also be defended. *See* text accompanying notes 84-85.

75. For an explanation of how benefits legally accrue in a pension plan, *see generally* D. McGill, Fundamentals of Private Pensions 262-325 (5th ed, 1984); G. Boren, *supra*, note 17, Ch. 8;D. Grubbs, Funding, *supra* note 69. Assume a pension plan that provides that an employee will receive at age 65 a monthly pension equal to $100 times his years of service. In such a plan an employee who has ten years of service has legally accrued a benefit of $1,000. An employer could fund this benefit by contributing in each year an amount that after appropriate actuarial discounting will yield a sum of money when the employee reaches age 65 sufficient to pay the employee $100 each month for the employee's life. Thus, for a 30 year old employee, the employer would contribute that sum of money that in 35 years (when the employee's benefit commences) will have grown to a sufficient sum to pay the employee $100 per month for life. In the next year, when the employee is age 31, the employer will contribute that sum of money that in 34 years will have grown to a sufficient sum to pay the employee $100 per month. Because there is a shorter period for interest to accumulate as the employee ages, contributions under this method must increase in every year, until the final year when the employer would have to contribute the exact sum of money sufficient to pay the promised benefit. Thus, in the case of an aging workforce this method of funding can result in extraordinarily large contributions in later plan years.

To avoid the prospect of an employer having to contribute crippling amounts at the end of a plan's life cycle, the Code permits funding methods that allow funding of anticipated benefits before they have accrued under the plan. *See* I.R.C. §§ 404(a)(1), 412 (1988); *see generally*, D. Grubbs, *supra*, at 6-7. The Code does this by permitting employers to anticipate total benefits under a plan and then allocate the cost of those benefits in a way that would result in the anticipated annual costs being a level dollar amount or a level percentage of payroll in each plan year. *See* D. McGill, *supra*, at 300.

Employers may also, in some situations, fund benefits after they accrue under the plan. For example, an employer could set up a plan that awards benefit accruals for years prior to the plan's existence. Such "past-service" credits immediately become accrued liabilities of the plan, but the employer may fund them gradually over a period of years that may be as long as 30 years. *See* I.R.C. § 412(b)(2)(B) (1988).

load contributions more favorably than those who are either unable or unwilling to. This Article's suggested rules avoid this disparity of treatment because early contributions to a pension plan will not result in exempting the earnings of such contributions from tax during the period of accumulation.

b. Equality Among Employees

Current law imposes a lower effective tax rate on qualified plan benefits than it does on cash compensation. This reduces the degree of both horizontal and vertical equity in the system. Professor Zelinsky never explains why this is a less serious normative concern than taxing participants in qualified plans at too high a rate.

V. MULTIEMPLOYER PLANS

Multiemployer plans are plans "to which more than one employer is required to contribute [and] which is maintained pursuant to one or more collective bargaining agreements."[76] Such plans are common in industries such as construction or coal mining, in which employees frequently change employers within the industry.[77]

The tax regime proposed in this Article is not easily adapted to such plans, for plan assets cannot be treated as the property of any given employer. An initial but not insoluble puzzle would be the appropriate tax rate on plan investments. A second, and more difficult problem, would be how to apportion the deductions for actual benefit payments. A retiree may have worked for many different employers during the course of her career, all of whom would have contributed toward her benefits. Apportioning the deduction would be nearly impossible.

Such plans, however, could be taxed in a manner that mimics this Article's suggested regime. For example, the trust could pay tax on investment income at a specified rate, and the employees would pay tax on benefits as received at their marginal tax rates.[78]

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76. ERISA § 3(37)(A), 29 U.S.C. § 1003(37) (1988).

77. *See* G.BOREN, *supra* note 17, at § 1:17.

78. Assuming a single rate for all taxpayers, the regime described in the text for multiemployer plans—taxing plan income as it is earned and taxing plan participants on their benefits as received—would have the same result as a regime in which the trust was taxed on plan income *and* plan contributions but received a deduction for benefits paid and not taxed to the employee or received no deduction for benefits paid and taxed to the employee.

The question, then, is what tax rate would be appropriate for the trust.

There are a number of possibilities: a rate based on the tax rates of contributing employers; a rate based on the tax rates paid by participating employees; or a flat rate applicable to all multiemployer plans.[79] Professor Zelinsky could find fault with any of these possibilities, and none are without problems.[80] Professor Zelinsky, however, has not made the case that these problems are more serious than the distortions in horizontal and vertical equity that occur under current law.

VI. Some Concluding Reflections on Professor Zelinsky's Analysis

I have, to this point, attempted to meet Professor Zelinsky's argument on its own terms and not to critique his brand of tax expenditure analysis. In conventional tax expenditure analysis, the term "tax expenditure" refers to a tax subsidy that results from a departure from the normative structure of an income tax, which has as its provenance the familiar Haig-Simons formulation of net economic income equaling consumption plus change in net worth over a given period.[81] Deferring tax on annual increases in pension

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See Halperin, *supra* note 28, 521-23.

79. A regime that imposes a flat tax on all qualified plans is discussed *infra* at text accompanying notes 84-85.

80. Taxing a plan's income at any rate—whether a rate based on the assumed average rate of participants, or sponsoring employers, or a flat rate for all plans—raises issues because the tax rate used will be different from that of many of the plan's participants. Thus, some taxpayers would be overtaxed, while others would be undertaxed. These issues are considered *infra* text accompanying notes 84-85, in a discussion of whether taxing trust income at a flat rate satisfies Professor Zelinsky's criteria.

It may also be troublesome to tax multiemployer plans on a different basis than other plans. However, the law already draws many distinctions between multiemployer and single employer plans. *See, e.g.*, 29 U.S.C. § 186(c)(5) (1988) (such plans subject to regulation under the Taft-Hartley Act); I.R.C. § 411(a)(2)(C) (1988) (special vesting rules for multiemployer plans); I.R.C. § 410(b)(3) (1988) (excluding employees who are covered by certain collective bargaining agreements from consideration of participation rules); ERISA § 4022A, 29 U.S.C. § 1322a (1988) (different Pension Benefit Guaranty Corporation benefit guarantees for multiemployer plans); ERISA § 4006(a)(3)(a)(iii), 29 U.S.C. § 1306 (1988) (different PBGC premiums for multiemployer plans); ERISA § 4201, 29 U.S.C. § 1341 (1988) (providing withdrawal liability for employer who withdraws from underfunded multiemployer plan). Moreover, the nature of such plans—negotiated plans over which the employer does not have control—suggests that such plans exist principally for purposes of the employees (or the union) rather than the employer and that a tax should not necessarily be pegged to that of the sponsoring employer. It would also, of course, be possible to subject all plans to the regime suggested in the text or to a flat tax on pension plan earnings.

81. *See* Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments*

wealth departs from this formulation because such increases add to a participant's net worth. Thus, Haig-Simons purists would understand our pension tax system as a generator of tax expenditures without further inquiry.

The concept of a normative income tax is, however, more flexible, and less encompassing, than the economic definition of income. It excludes items "which economists would cover under the general economic definition of income but historically have not been regarded as essential aspects of the structure of the Sixteenth Amendment income tax."[82] Professor Zelinsky's argument derives its energy from this aspect of the definition of a normative tax:

> It is not surprising that ideal notions of income have been developed by economists like Haig and Simons while the concept of a normative income tax is largely identified with legal scholars. The world of economists is often a rarefied one in which questions like administrability and taxpayer liquidity play, if any role, a decidedly secondary one. For lawyers, on the other hand, such considerations are critical to the design of an income tax.[83]

Evaluation of alternative tax regimes in light of such considerations is the means by which Professor Zelinsky defends current tax rules. This is a fuzzy kind of tax expenditure analysis; the concepts that Professor Zelinsky employs are supple, subject to manipulation in the hands of those skilled in policy debate. I have tried, in this Article, to demonstrate how an alternative regime could satisfy Professor Zelinsky's criteria more satisfactorily than current law, although I have no doubt that Professor Zelinsky can construct plausible counterarguments from the same concepts.

One can also argue, in the same fuzzy way, that at least some of the alternative regimes considered by Professor Zelinsky's article fare better under his criteria than he suggests. For example, to my mind Professor Zelinsky's case against taxing pension plan earnings at a flat tax—a proposal that is now attracting serious attention from policymakers[84]—is not compelling.

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and Emerging Issues, 20 B.C.L. REV. 225 (1979).

82. *Id.*

83. Zelinsky, *supra*, note 2, at 326.

84. *See* Graetz, *supra* note 1, at 908 (arguing for a flat tax on retirement plan income or assets). At a recent conference sponsored by the Employee Benefit Research Institute, Ann L. Combs, Deputy Assistant Secretary of the Department of Labor, indicated that "some level of taxation" would not destroy the pension system, 17 Pens. Rep. (BNA) 747 (May 7, 1990), and David Lindeman, Director of the Pension Benefit Guaranty Corporation Department of Corporate Policy and Research stated that a 5% tax on pension fund income

A flat tax is supremely administrable, simple, and measurable. Professor Zelinsky, however, argues that a flat tax regime would sacrifice equity concerns because taxpayers whose marginal tax rates are high would benefit more from the differential between their rates and the flat tax than would taxpayers for whom the differential is smaller. But this argument could be applied with equal force to our current tax regime, in which the tax benefits of deferral is greatest for taxpayers whose marginal rates are highest. Professor Zelinsky also argues that taxpayers whose marginal rates are lower than the flat tax on pension earnings will suffer a tax penalty. I have suggested earlier in this Article that such a position is inconsistent with a belief in a functioning market for labor. Moreover, taxpayers can structure their compensation arrangements in such a way as to avoid excess tax. In any event, the size of a tax penalty in most situations would likely be minuscule in dollar terms.[85] Finally, Professor Zelinsky suggests that in the future individual tax rates may change, necessitating a need to adjust the flat tax on pension earnings. But changes in the rate structure affect all tax shelters, including today's qualified plans, by making them more or less attractive investment vehicles. In addition, if rates were suddenly to be increased, some taxpayers would doubtlessly argue that qualified plan participants are entitled to some special Congressional dispensation because the tax rate in the year of plan contribution would be lower than the tax rate in the year of benefit distribution.

The flat tax does offer some distinct advantages over current law. Current law, by providing middle-income and high-income taxpayers with significant tax savings if their employers defer their

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"would not profoundly change the administrative or policy environment", *id.* at 748. A study by the Congressional Budget Office estimated that such a tax would raise $39.3 billion over five years, Congressional Budget Office, *supra* note 21.

85. For example, assume, as Professor Zelinsky does, that the flat tax rate would be 15%. *See* Zelinsky, *supra* note 2, at 358. Now assume a single taxpayer, with under $5,000 in income, the cut-off point between a 0% tax rate and a 15% rate. I.R.C. §§ 63(c)(2)(C)(standard deduction) & 151(d)(1)(personal exemption). Many working employees with such low incomes will be quite young. In defined benefit plans, contributions related to benefit accruals of young employees are small because of the long period in which the contribution will earn interest before the benefit is paid. *See supra* note 75. It is probable that the difference in tax on the plan contribution would be insignificant in dollar terms. Moreover, if the value of an employee's pension accrual was great, making the tax significant, the value of the accrual would probably push the employee into the 15% bracket. Finally, assuming that the earnings, and marginal tax rates, for employees generally increase over their lives, the overtaxation in early years might be compensated for by undertaxation that would occur when the employee's personal tax rates exceeded those of the trust.

compensation, must necessarily encourage pension plan formation far beyond what would occur in a theoretical world in which pension savings and other savings were subjected to an identical tax rate. Imposing some tax on pensions would make the choice between deferred and immediate compensation less skewed and closer to what would occur in a world without tax. Imposing some tax would also ameliorate to some extent the horizontal equity problems that result because use of pension plans differs among taxpayers.

Professor Zelinsky suggests that his brand of tax expenditure analysis has allowed him to meet tax expenditure theorists "on their own ground by assuming the propriety of seeking a normative tax."[86] This is not, however, quite correct, for Professor Zelinsky's understanding of the "structure of a normative tax" is broader than that of tax expenditure theorists such as Professors Stanley Surrey and Paul McDaniel:

> The Treasury Department, in establishing the first tax expenditure tabulation in 1968, basically utilized the general economic definition of income . . . . The Treasury modified this general definition by adding a reference to "the generally accepted structure of an income tax." The modification had the narrow, explicitly described function of excluding from the category of tax expenditures certain nontaxable items which economists would cover under the general economic definition of income but which historically have been regarded as essential aspects of the structure of the Sixteenth Amendment income tax. These nontaxable items include such things as unrealized appreciation in the value of an asset and income imputed from an asset.[87]

It is doubtful whether this approach to the normative structure of an income tax would extend to the legislatively developed rules applicable to qualified plans. There is certainly no historic inevitability to the favored tax niche that such plans occupy.

Perhaps more important than these questions is why we should be concerned with molding special tax rules for employer-sponsored defined benefit plans. It is necessary for the structure of our income tax to exclude imputed income and unrealized appreciation because there is no broadly acceptable way to tax such income and because taxpayers cannot avoid ownership of assets that produce such income. In contrast, employers could stop sponsoring

86. Zelinsky, *supra* note 2, at 327.
87. Surrey & McDaniel, *supra* note 81.

defined benefit pension plans. Divining a normative structure for taxation of such plans is necessary for defined benefit plans, then, only if we want employers to sponsor defined benefit plans.

I have argued that Professor Zelinsky is mistaken in his view that there are no acceptable alternatives to current law's treatment of defined benefit plans, but even if these reasons are not totally persuasive, the question still remains why should we be concerned if the tax system, by making no special allowances for funded retirement plans, discourages the formation of such plans. Having tax laws of any sort necessarily discourages some types of economic arrangements.

There is substantial evidence suggesting that qualified pension plans exist in large measure precisely because of the favored niche they occupy in our tax structure.[88] Professor Zelinsky either doubts that the tax laws gave birth to funded retirement arrangements or believes that the tax law is obliged to nurture its progeny. In this doubt, or in this belief, may lie the explanation for my disagreement with Professor Zelinsky.

To return to the question posed, we should be concerned with how the tax law treats retirement plans if we believe that such plans are worthwhile and should be encouraged, or at least not discouraged. From this perspective, Congress might have developed our present laws to not discourage retirement plans, even though the rules subsidize such plans vis-a-vis cash compensation. Alternatively, Congress could have developed current law to encourage the formation of such plans. In either event, though, the reason that Congress would have prescribed special—ultimately favorable—rules for taxation of retirement plans would have been its determination that retirement plans were worthwhile and important.

If this view is correct, then it can hardly be objectionable that Congress over the years has honed its view of what types of retirement plans the tax laws should encourage, or at least not discour-

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88. Professors Langbein and Wolk point out that the private pension system experienced its greatest growth during a period in which there were increases in both income tax rates and the percentage of the population subject to the tax. J.LANGBEIN & B.WOLK, *supra* note 48, at 14-15. *See also* A.MUNNELL, *supra* note 21, at 30-31.

Critics of this position might counter that pension plans existed before this nation adopted its 16th amendment income tax. These plans, however, were not funded on a sound basis and could be revoked by the employer for virtually any reason, with the employees receiving no benefits. *See generally*, Stein, *Raiders of the Corporate Pension Plan: The Reversion of Excess Plan Assets to the Employer*, 5 AM. J. TAX POL'Y 117, 136-43 (1986).

age. The policy-oriented rules that Professor Zelinksy would eliminate specify the contours of the type of retirement arrangements that Congress wishes to encourage through favorable tax treatment. It is certainly debatable whether the complexity of some of these requirements is sufficiently justified by important retirement policy goals, just as it is debatable whether tax dollars should subsidize private retirement arrangements at all. But it seems to me that such arguments should be framed forthrightly in terms of policy goals, not buried in theories of why current law does or does not generate tax expenditures.