UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 66 | Number 2 Article 4

1-1-1988

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THE TAX TREATMENT OF QUALIFIED PLANS: A CLASSIC DEFENSE OF THE STATUS QUO

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The current tax treatment of qualified pension and profit sharing plans has been criticized by commentators as an unfair and expensive tax expenditure. In this Article, Professor Zelinsky challenges this characterization and defends the current treatment of qualified plans on the ground that it is at least as attractive as its alternatives and superior to many of them. After evaluating the current treatment and the alternatives under the criteria of measurability, administrability, liquidity, equity, and simplicity, Professor Zelinsky concludes that the present treatment of qualified plans can be viewed as an acceptable part of a normative income tax.

I. INTRODUCTION

Qualified pension and profit sharing plans generate immediate deductions for contributing employers, but deferred income for participants.[1] The earnings of qualified plans accumulate tax-free.[2] The Treasury Department and the Joint Committee on Taxation list the Internal Revenue Code ("the Code") provisions pertaining to qualified plans as tax expenditures, indicating that this statutory scheme is inconsistent with a normative income tax.[3] Many reform-oriented commentators similarly question the existing treatment of qualified plans and view it as an unfair and expensive means of implementing national retirement policy.[4]

This Article suggests that qualified plans, as presently treated by the Code, are not tax expenditures and that the essentials of current law should not be viewed as violative of normative income tax principles. This Article is thus an

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1. I.R.C. § 402(a)(1) (1982) delays taxation of qualified plan participants until amounts are "actually distributed" to them. I.R.C. § 404(a) provides a deduction to an employer when "contributions are paid by an employer to" a qualified plan. *Id.* § 404(a).

2. *See id.* §§ 501(a), 801-818 (1982, Supp. 1985 & West Supp. 1987).

3. *See* Oberst, *A Perspective Of The Qualified Plan Tax Subsidy*, 32 BUFFALO L. REV. 603, 613-14 (1983); *Fulfilling The Private Pension Promise*, 33 TAX NOTES 784 (1986). For the Joint Committee's tax expenditure estimates for 1988 to 1992, see Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1988-1992*, Daily Tax Rep. (BNA) No. 39, at J-1 to J-8 (March 2, 1987). For the analysis of the Congressional Budget Office, see Pensions: CBO Says Tax-Favored Plans Remain Most Costly Tax Expenditure, Add Little to Savings Rates, Daily Tax Rep. (BNA) No. 87, at G-2 (May 7, 1987).

4. *See infra* notes 59-88 and accompanying text.

effort to meet the critics of current law on their own ground, challenging their characterization of the status quo as a tax expenditure. The Article argues that the present treatment of qualified plans, in its essentials, fits comfortably into our conception of a normative income tax without appealing to expenditure-type considerations such as the encouragement of retirement savings. The status quo vis-a-vis qualified plans is not perfect. Neither, however, are the alternatives. Current law, on balance, is as attractive as those alternatives, superior to some of them, and consequently an appropriate part of a normative income tax.

One way to approach the position advanced here is to suppose a world in which no choices have been made as to the income tax treatment of qualified plans. Suppose further that Congress is not interested in encouraging such 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.

The stakes involved in this area are considerable. Even before the Tax Reform Act of 1986 ("the 1986 Act"),[5] the Treasury and Joint Committee viewed qualified plans as among the most costly of tax expenditures.[6] The 1986 Act, while restricting many of the tax shelters of prior law,[7] made no fundamental changes to the treatment of qualified plans.[8] If the present treatment of qualified plans constitutes a tax expenditure, and if Congress continues its effort to purge the tax law of such provisions,[9] the Code's treatment of qualified plans is a logical place for Congress to examine. If existing law is appropriately part of a normative income tax, however, the qualified plan provisions should lose their status as a prime target for future efforts aimed at tax preferences.

The characterization *vel non* of current law as a tax expenditure has implications for another important policy question, the appropriate treatment of pension reversions. Critical to the argument that employers should not recoup pension reversions is the notion that employers have been given tax benefits as a

5. Pub. L. No. 99-514, § 141, 100 Stat. 2085 (1986).

6. *See supra* note 3 and accompanying text.

7. *See, e.g.*, I.R.C. § 469 (West Supp. 1987).

8. The 1986 Act did reduce some limits on contributions and benefits and did refine the Code's participation, coverage, and nondiscrimination rules for qualified plans. However, the basics of current law—immediate deductions for employers, deferred taxation for employees, tax-free accumulations in between—were not affected by the 1986 Act. *See* §§ 1105-47 of the 1986 Act.

9. My view is that the case against tax expenditures is frequently overstated. *See* Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973 (1986). Nevertheless, the strategy of this Article is to assume, *arguendo*, that the characterization of the Code's qualified plan provisions as a tax incentive, if true, would compel the alteration of present law, and to attack the validity of that characterization. Some believe the normative-expenditure distinction is not workable. For general expositions of this view, see Bittker, *Accounting For Federal "Tax Subsidies" in The National Budget*, 22 NAT'L TAX J. 244 (1969). For a contrasting view, see McIntyre, *A Solution to The Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 79 (1980). However, the strategy of this article is to accept the premises of those opposing current law, including the normative-expenditure distinction, and to defend the present provisions of the Code on these terms.

quid pro quo for pension coverage.[10] If current law is not a tax benefit, however, but rather reflects a normatively proper treatment of deferred compensation, this argument loses its force.

This Article initially reviews the present legal treatment of qualified plans,[11] discusses the views of commentators who conclude that present treatment violates the premises of a normative income tax, and reviews the proposed alternatives to current law.[12] It discusses the concept of a normative income tax, then outlines criteria for evaluating the propriety of present law as part of a normative income tax and previews the application of those criteria to current law and the suggested reforms.[13] Next, in the context of defined benefit pension plans, the Article explores the problems of a commonly suggested alternative to the status quo—taxing employees on plan benefits when earned rather than when ultimately distributed—and compares that alternative to the existing treatment of qualified plans.[14] It then examines, as to defined benefit plans, the limitations of a second reform proposal: taxing employees on plan contributions at the time such contributions are made.[15] Next, the Article discusses the possibility of taxing defined benefit plans on their investment earnings[16] and of denying employer deductions until benefits are distributed to participants.[17] The Article concludes by exploring reform proposals as they would apply to profit sharing and defined contribution pension plans, and by contrasting the nature of nonqualified deferred compensation arrangements with qualified plans.[18]

I conclude that, ironically, the existing tax treatment of qualified plans, widely criticized by tax reformers, bears a close resemblance to at least one provision of the Code with which some reformers have made their peace and to at least one proposal which many reformers favor. I ultimately embrace a classic defense of the status quo: the alternatives are no better and, in some cases, worse. Any scheme for taxing qualified plans entails problems and trade-offs. On balance, present law resolves these conflicts as well as any of the reform proposals and better than some, and thus ought to be accepted as part of a normative income tax.

II. THE EXISTING TREATMENT OF QUALIFIED PLANS

Several themes can be extracted from the morass that is the legal framework governing qualified plans. Such arrangements may either be pension or profit sharing plans.[19] The former embody an employer's commitment to contribute to employees' retirements, regardless of the employer's economic circum-

10. R. IPPOLITO, PENSIONS, POLITICS, AND PUBLIC POLICY 36-41 (1986).
11. *See infra* notes 19-58 and accompanying text.
12. *See infra* notes 59-88 and accompanying text.
13. *See infra* notes 89-123 and accompanying text.
14. *See infra* notes 124-70 and accompanying text.
15. *See infra* notes 171-90 and accompanying text.
16. *See infra* notes 190-93 and accompanying text.
17. *See infra* notes 194-95 and accompanying text.
18. *See infra* notes 195-206 and accompanying text.
19. Treas. Reg. § 1.401-1(a)(1)-(2) (1976).

stances.[20] The latter, in contrast, evidence an employer's ability to contribute if it has the financial capability and willingness to do so.[21] Pension plans are typically of the defined benefit type, under which the employer's commitment is formulated as a benefit to which the employee will be entitled at retirement age.[22] That benefit is usually specified as an annuity, commencing at retirement age, equalling a percentage of the employee's average compensation over the course of his career or over certain portions of that career.[23]

In the defined benefit context, the employer's contribution to the plan is determined each year by an actuary who calculates the amount needed to fund the promised benefits on a sound basis. That amount reflects a wide array of actuarial assumptions as to plan earnings, employees' long-term salaries, and death, retirement, and disability projections. Variances between actual experience and these assumptions will lead to adjustments in the employer's contributions. If the plan earns less than expected, for example, the employer must contribute the difference, having committed to a promised level of benefits.[24] The defined benefit pension plan is thus the classic retirement arrangement, providing the participating employee with a predictable postemployment income towards which he works during his career.

On the other hand, under a defined contribution pension plan, the employer's obligation is specified as a current contribution of a particular percentage of the employee's present compensation.[25] Under a defined contribution arrangement, the employee's eventual benefit is the amount to which these accumulated contributions and their earnings have grown. As earnings cannot be guaranteed and investment losses are possible, the employee's retirement payments under a defined contribution plan are unknown until actual receipt. Under either a profit sharing plan or a defined contribution pension plan, an account is maintained for each participating employee. That account is credited with all contributions made on the employee's behalf and a pro rata share of the earnings of the plan. Each account is debited with a proportionate amount of the losses sustained by the plan. The employee absorbs the economic risk of the plan's performance because his ultimate benefit consists of the amount to which his account has grown or fallen.[26]

To ensure the participation of rank-and-file employees, qualified plans must

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20. *Id.* § 1.401-1(b)(1)(i).

21. *Id.* § 1.401-1(b)(1)(ii). The Tax Reform Act of 1986, however, amended the Code to permit nonprofit employers to establish profit sharing plans. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1136, 100 Stat. 2085, 2485-86 (codified as amended at I.R.C. § 401(a)(27) (West Supp. 1987)).

22. *See* D. BRADFORD, BLUEPRINTS FOR BASIC TAX REFORM 52 (2d ed. 1984); R. IPPOLITO, *supra* note 10, at 36-41; D. MCGILL, FUNDAMENTALS OF PRIVATE PENSIONS 101-09 (5th ed. 1984).

23. R. IPPOLITO, *supra* note 10, at 37-42; D. MCGILL, *supra* note 22, at 500-08.

24. *See* G. GILBERT, G. LACHOWICZ & J. ZID, ACCOUNTING AND AUDITING FOR EMPLOYEE BENEFIT PLANS 7-1 to -20 (1978); D. MCGINN, ACTUARIAL FUNDAMENTALS FOR MULTIEMPLOYER PLANS 25-31 (1982). *See generally* D. MCGILL, *supra* note 22, at 237-59 (discussing various actuarial cost factors).

25. D. BRADFORD, *supra* note 22, at 52; G. GILBERT, G. LACHOWICZ & J. ZID, *supra* note 24, at 1-6 to -7; D. MCGILL, *supra* note 22, at 99-104.

26. D. MCGILL, *supra* note 22, at 110.

cover large numbers of full-time, nonunionized personnel. Moreover, in their provision of benefits and contributions, qualified plans may not discriminate in favor of highly-compensated employees. Intricate statutory provisions implement these coverage, participation, and nondiscrimination requirements.[27]

Whatever the type of qualified plan, the employer deducts its contributions, subject to certain limits.[28] If contributed funds are held by a trust, the trust earnings are free of federal income tax under section 501(a) of the Code.[29] If contributed funds purchase annuity contracts for participants, such funds grow tax-free pursuant to the Code provisions for insurance companies.[30] In either case, federal income tax comes due only when distributions are actually paid to employees by the plan.[31]

In addition to retirement benefits, qualified plans may provide disability and death payments.[32] Under certain circumstances, the Code requires survivors' payments for spouses of qualified plan participants.[33] In addition, profit sharing plans may authorize preretirement distributions on account of hardships other than death and disability.[34]

To ensure that benefits will be available at retirement, the Code forbids employees' creditors from attaching such benefits prior to actual distribution, and employees are largely proscribed from assigning them.[35]

Central to the current tax treatment of qualified plans, as well as certain reform possibilities, are the related concepts of accrued benefits and vesting,[36] or, as the Code somewhat misleadingly refers to it, nonforfeitability.[37] In the case of a defined benefit pension plan, an employee typically accrues, or earns, his ultimate benefit in annual increments. Consider an employee hired thirty-three years before the plan's retirement age who is projected to receive a pension of $10,000 per year at retirement based on his present salary. Assume that the employee's current annual compensation is $20,000 and that the plan promises a yearly benefit equal to fifty percent of the employee's highest annual compensation. Hence, the anticipated benefit equals $10,000. Further assume that benefits accrue under the plan in a typical pattern of equal, annual increments. At the end of his first year of participation, our hypothetical employee has accrued an annual pension of $303, representing one year's effort towards his eventual pension of $10,000. At the end of his second year, the participant will have accrued

27. I.R.C. §§ 401, 410-11, 416-17 (1982, Supp. 1985 & West Supp. 1987). For a commentary on the vesting rules of I.R.C. § 411, see Osgood, *Qualified Pension and Profit-Sharing Plan Vesting: Revolution Not Reform*, 59 B.U.L. REV. 452 (1979). For a commentary on I.R.C. § 410, see Note, *Discrimination in the Coverage of Retirement Plans*, 90 YALE L.J. 817 (1981).

28. I.R.C. §§ 404(a), (j)(1), 412, 415(a)-(c) (1982, Supp. 1985 & West Supp. 1987).

29. *Id.* § 501(a) (1982).

30. *Id.* §§ 801-818 (1982, Supp. 1985 & West Supp. 1987).

31. *Id.* § 402(a)(1) (1982).

32. *See* D. MCGILL, *supra* note 22, at 149-63; D. MCGINN, *supra* note 24, at 16.

33. I.R.C. §§ 401(a)(11), 417 (West Supp. 1987).

34. Treas. Reg. § 1.401-1(b)(1)(ii) (1976).

35. I.R.C. § 401(a)(13) (West Supp. 1987).

36. G. GILBERT, G. LACHOWICZ, & J. ZID, *supra* note 24, at 5-3 to -5.

37. *See* I.R.C. § 411 (West Supp. 1987).

an annual pension of $606 and, at the end of his third year, $909. If the employee leaves at that point, his entitlement to a pension, if any, will be based, not on the $10,000 per year he was projected to receive, but on the $909 annual pension he stayed long enough to earn. An employee's accrued benefit is thus the amount to which he has a tentative claim based on his past service and salary.

An employee is not entitled to a benefit merely because he has accrued it. Under the rubric of vesting, an employee's ultimate right to his accrued benefit is determined by his total years of service with the sponsoring employer. The employer can, but rarely does, establish immediate vesting of all accrued benefits. In that case, our hypothetical employee will be entitled to $909 per year at retirement age even if he leaves after three years of work. The Code permits employers to condition entitlement to a benefit on the satisfaction of some minimum years of service. One permitted schedule requires an employee to work at least five years before his accrued benefit becomes nonforfeitable.[38] In the case of an employee with three years of service, the termination of employment would cause the loss of his entire accrued benefit. An alternative schedule vests an employee in twenty percent of his accrued benefit after three years of service.[39] Were this the case for our hypothetical employee, he would be entitled at retirement age to a pension of $181.80 per year, twenty percent of $909.

Under a profit sharing or defined contribution pension plan, the employee's accrued benefit is the balance in his account. If an employee terminates prior to the plan's normal retirement age, the plan's vesting schedule is applied against his account balance to determine the amount to which the employee is entitled.[40]

On payment to participants or participants' beneficiaries in lump sums, distributions from qualified plans frequently are eligible for taxation on favorable terms. Preferential rates, premised on averaging and capital gain concepts, may be available for such lump sums.[41] Alternatively, part or all of such lump sums may be transferable tax-free to individual retirement accounts.[42] Absent such favorable treatment, plan distributions are taxable as ordinary income under normal tax rules.[43]

Four additional aspects of current law buttress the security of employees' interests in qualified plans. First, the Pension Benefit Guaranty Corporation ("PBGC") is a government-established insurance corporation comparable to the Federal Deposit Insurance Corporation or Federal Savings and Loan Insurance Corporation.[44] Most defined benefit pension plans must pay annual premiums to

38. *Id.* § 411(a)(2)(A).
39. *Id.* § 411(a)(2)(B).
40. *Id.* § 411(a)(7)(A)(ii) (1982).
41. *Id.* § 402(e) (West Supp. 1987); § 1122(h)(3) of the 1986 Act.
42. *Id.* § 402(a)(5)-(7).
43. *Id.* § 402(a)(1) (1982).
44. The PBGC was established by the Employee Retirement Income Security Act of 1974. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 4002, 88 Stat. 829, 1004-06 (codified as amended at 29 U.S.C. § 1302 (1982)).

the PBGC. In turn, the PBGC guarantees minimum benefit levels to plan participants. If a plan's assets prove inadequate to provide promised benefits, the PBGC will pay from its resources the difference between the benefits the plan can afford and the insured minimum.[45]

Although most defined benefit arrangements are covered by the PBGC and its insurance program, some are not, such as the defined benefit plans maintained by small professional service employers.[46] Profit sharing plans and defined contribution pension plans are not protected by the PBGC because, by definition, such plans do not promise a benefit that can be guaranteed. After the employer has made his contribution, the employee has no assurance his account will grow to any particular level.[47] If investment performance is bad enough, his account can actually decline.

Second, the Code subjects pension plans to minimum funding requirements.[48] For defined contribution plans, the annual minimum is the yearly contribution specified in the plan.[49] If, for example, the employer's annual obligation under the plan is ten percent of each participant's current compensation, the employer failing to make that contribution, in whole or part, is subject to a penalty tax.[50] In the defined benefit context, the annual minimum to avoid such taxation is the actuarially required amount necessary to fund the benefits promised under the plan.[51]

Third, the Employee Retirement Income Security Act of 1974 ("ERISA") imposes on key plan personnel federally enforceable fiduciary obligations,[52] modelled on the traditional liabilities of trustees, as well as prohibitions on certain suspect transactions.[53] Violation of these rules results in personal liability of the offending fiduciary to the plan[54] and in the payment of penalty taxes.[55]

Fourth, once contributions are made, they are irrevocable in the sense they cannot be reclaimed by the employer unless all liabilities have been satisfied under the plan.[56] Even if the employer is entitled to the return of excess funds, it will pay an extra tax of ten percent on such reversion.[57]

Much of this complicated framework is unnecessary or, alternatively, is not attributable to the essential policies of present law, current deductibility for employers, taxation on payment for employees, and tax-free accumulation by plans in between.[58] Some aspects of existing law, such as the provisions favorably

45. *See* 29 U.S.C. §§ 1305-68 (1982).
46. *Id.* § 1321(b)(13), (c)(2).
47. *Id.* § 1321(b)(1).
48. I.R.C. § 412(b) (1982).
49. *Id.*
50. *Id.* § 4971.
51. *Id.* § 412(b), (g).
52. 29 U.S.C. § 1104 (1982).
53. I.R.C. § 4975 (1982, Supp. 1985 & West Supp. 1987).
54. 29 U.S.C. § 1109 (1982).
55. I.R.C. § 4975(a)-(b) (1982).
56. *Id.* § 401(a)(2) (1982).
57. *Id.* § 4980 (West Supp. 1987).
58. *See infra* text accompanying notes 59-88.

taxing lump sums and permitting tax-free transfers of lump sums to individual retirement accounts, unjustifiably embellish, extend, or modify these basic policies. Other features of current law, such as the nondiscrimination, participation, and coverage rules of the Code, are erroneously premised on the view that the present treatment of qualified plans constitutes a tax expenditure that must be controlled. Freed of these embellishments and misconceptions, the essentials of present law could be embodied in a statute far simpler than the existing qualified plan provisions of the Code.

III. The Case Against the Existing Income Tax Treatment of Qualified Plans

The present treatment of qualified plans has not met with favor among reform-oriented commentators, who largely have denounced current law as a deviation from normative income tax principles. Once existing law is deemed inconsistent with a normative income tax, it is a short step to the invocation of the now-familiar indictment of tax expenditures: they are unfair, giving the greatest assistance to high bracket taxpayers and no assistance to those too poor to pay tax; they are inefficient, rewarding taxpayers for behavior in which they would have engaged anyway. To the extent they do affect taxpayers' actions, tax expenditures distort the appropriate allocation of resources. They are uncontrollable, available to any taxpayer desiring to use them.[59]

In this vein, Professor Surrey criticized the "deferral" aspect of existing law: the immediate deductibility of employer contributions notwithstanding the delay until receipt of employee taxability. For Professor Surrey, this deferral problem is compounded by the likelihood that, at retirement, the employee's tax bracket will be lower than during his working career.[60] Professor Surrey did not prescribe a specific reform of this "preferential tax treatment,"[61] though he left no doubt that current law "is clearly unfair and inadequate."[62]

Richard Goode is equally unhappy with the "deferment privileges"[63] of existing law, labelling the status quo "inequitable."[64] With reservations, Goode finds it "fair and feasible" for vested employees to recognize employer contributions as income when made and to report as income the subsequent earnings of qualified plans.[65] "[L]imiting the extent of tax deferral under employer plans," Goode declares, is "consistent with income tax principles," though not "attractive to Congress."[66]

In its influential 1984 reform study, the Treasury Department similarly

59. *See* S. Surrey & P. McDaniel, Tax Expenditures 82-89 (1985). For another recent summary, see Shannon, *The Tax Expenditure Concept In The United States And Germany: A Comparison,* 33 Tax Notes 201 (1986).

60. S. Surrey, Pathways to Tax Reform 93 (1973).

61. *Id.* at 127.

62. *Id.* at 206.

63. R. Goode, The Individual Income Tax 111 (rev. ed. 1976).

64. *Id.* at 112.

65. *Id.* at 111-12.

66. *Id.* at 114.

characterized the present treatment of qualified plans as "tax-favored."[67] However, the Treasury proposed only minor changes for qualified plans, accepting the use of tax incentives for "the encouragement of savings for retirement."[68]

The shared premise for these commentators is the accretionist approach to the income tax typified by the Haig-Simons definition of income. From this perspective, an individual's income consists of the accretion to his economic power during the relevant reporting period. Such increase, embodying his taxpaying capacity, is either consumed or saved by the taxpayer. This leads to the well-known formula that an individual's income is the sum of his consumption and savings.[69]

The accretionist perspective is best understood as an ethical approach to taxation, concerned with the equity with which burdens are distributed rather than the economic efficiency of the tax system.[70] As an economic matter, the existing treatment of qualified plans has much to commend it; such plans under current law may compensate for the depressing effect of an income tax on savings.[71] Whether that claim is accurate, for Richard Goode and Professor Surrey it is essentially irrelevant. Their principal concern is for accurate measurement of taxpaying capacity so that tax burdens can be distributed equitably. If two employees are similarly situated, only one of whom is in a qualified plan, at the end of the year the tax system ought to impose a heavier burden on that employee because of the incremental wealth embodied in his plan participation.

Rigorous implementation of the accretionist perspective would lead to many changes to the Code even as reformed by the 1986 Act. Fidelity to the Haig-Simons definition implies the current taxation of unrealized appreciation, as it expands the taxpayer's present economic capacity.[72] A widely advocated variation of this proposal is constructive realization, the taxation of appreciation either when property is given away or on the owner's death.[73] By analogy, the accrual of pension benefits is like the appreciation of property, savings and therefore income under the Haig-Simons formulation. Hence, present law is characterized as embodying a deferral privilege, because the tax on participants' increased economic capacity via the plan is delayed until retirement.

67. 2 OFFICE OF THE SECRETARY, DEP'T OF THE TREAS., TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 336 (1984) [hereinafter TREASURY REPORT].

68. *Id.* at 341.

69. *See* D. BRADFORD, *supra* note 22, at 22; Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 7-10 (J. Pechman ed. 1977); Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility* (to be published in 7 AM. J. TAX POL'Y (1987)).

70. Hettich & Winer, *Blueprints and Pathways: The Shifting Foundations of Tax Reform*, 38 NAT'L TAX J. 423, 424 (1985).

71. *See* D. BRADFORD, *supra* note 22, at 7, 10, 23, 31; R. IPPOLITO, *supra* note 10, at 27-28; Bradford, *The Case for a Personal Consumption Tax*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 91-92 (J. Pechman ed. 1980).

72. *See* Goode, *supra* note 69, at 20-21; Wetzler, *Capital Gains and Losses*, in COMPREHENSIVE INCOME TAXATION 120-22 (J. Pechman ed. 1977); Yorio, *Equity, Efficiency, and The Tax Reform Act of 1986*, 55 FORDHAM L. REV. 395, 454 (1987).

73. Goode, *supra* note 69, at 20-21; Wetzler, *supra* note 72, at 120-22; Yorio, *supra* note 72, at 457.

Emil Sunley has presented the most extensive analysis of the reform possibilities in this area.[74] Sunley is firmly in the accretionist camp: "The accrual of pension rights would be considered income under the Haig-Simons definition of income. Employees each year would include in income the year-to-year increase in the present value of expected future retirement benefits."[75] Sunley concludes that the most feasible approximation of this treatment is the taxation to vested employees of employer contributions when made.[76] Under Sunley's scheme, at retirement, employees' payments from qualified plans would consist of a previously taxed component and an untaxed element reflecting the earnings generated by employer contributions.

Professor Wolk also is sharply critical of existing law, characterizing it as a "tax subsidy," which "is a costly and inadequate vehicle for achieving the apparent congressional goal of meeting the retirement needs of employees."[77] Like Emil Sunley, Professor Wolk would tax employer contributions to vested plan participants at the time such contributions are made.[78] Professor Wolk would also tax plan earnings to vested defined contribution participants but, in the defined benefit context, would tax plan earnings to the employer.[79]

Of those calling for change to the status quo, Professor Shakow is most optimistic that accrued benefits could be valued and taxed to employees when earned. "[T]he tax system could fairly easily implement" such a tax, he concludes, "although the decision to do so raises questions of national retirement policy."[80]

Professor Halperin has suggested reform of the tax treatment of nonqualified deferred compensation.[81] His analysis is equally applicable to qualified plans as is his proposal: the annual taxation of the earnings of deferred compensation at the employee's present rate.[82]

Professor Halperin's concern may be characterized as the equitable treatment of employees who perform services simultaneously, earning equal amounts but receiving compensation at different times. To use his example, consider an employee, permanently in the forty percent bracket, earning $10,000. Assume

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74. Sunley, *Employee Benefits and Transfer Payments*, in COMPREHENSIVE INCOME TAXATION 75 (J. Pechman ed. 1977).

75. *Id.* at 80.

76. *Id.* at 82.

77. Wolk, *Discrimination Rules For Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 463 (1984).

78. *Id.* at 469-70.

79. *Id.*

80. Shakow, *Taxation Without Realization: A Proposal For Accrual Taxation*, 134 U. PA. L. REV. 1111, 1138 (1986).

81. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506, 539 (1986); *see also* Warren, *The Timing of Taxes*, 39 NAT'L TAX J. 499, 501 (1986) (demonstrating by example that income deferral is not advantageous to taxpayers if the deferred amount is increased by the after-tax return in the interim).

82. Halperin, *supra* note 81, at 523. I should emphasize that Professor Halperin explicitly limits his recommendations to nonqualified deferred compensation. It is my judgment that his proposal for a tax on plan earnings ought to be considered with reference to qualified plans. *See also* D. BRADFORD, *supra* note 22, at 52 (advocating taxation of plan earnings, as they accrue, to either the employer or the employee, depending on whether earnings are assigned to employees by the plan).

also that the applicable rate of interest is ten percent and that the employee saves all income for two years. The employee will have a total of $6,741.60 after two years, reflecting both the initial taxation of $10,000 at forty percent and the taxation of interest accruing over the next two years.[83] For Professor Halperin, this is the normatively correct result, obviously violated by the present treatment of qualified plans. Under current law, the entire $10,000 would be conveyed free of tax to the plan, where it would accumulate undisturbed by the IRS. The final sum would be distributed for taxation for the first time after two years. To achieve parity, however, Professor Halperin notes it is unnecessary to tax the employee's $10,000 initially so long as the interest earned by the $10,000 is taxed currently at the employee's rate. Suppose a qualified plan received the initial $10,000 tax-free, but was subsequently taxed annually on earnings at the same forty percent rate as the employee. The entire balance, contributions plus net earnings, would then be distributed to the employee for taxation at the end of two years. At this final point, the employee in the plan would have the same $6,741.60 after taxes as if he had received his $10,000 on a current basis.[84] This result is not as paradoxical as it initially seems, because investment earnings under the proposed deferred arrangement will have been taxed three times, twice to the plan and once on distribution to the employee, but only twice to the employee under the current compensation payout.

Professor Halperin is therefore prepared to eschew taxation at the time of contribution so long as earnings are taxed annually at the employee's rate and on distribution the employee is in the same bracket in which he started.[85] As a second best solution, Professor Halperin is satisfied to tax currently the earnings on deferred compensation prior to distribution.

Professor Halperin would apply his annual tax on investment income only to nonqualified deferred compensation. Accepting the characterization of present law as a tax incentive, Professor Halperin is not prepared to expand his proposal to qualified plans.[86] However, for one unpersuaded of the advantages of existing law or believing retirement policy should be made outside the Code, Professor Halperin's proposal for an annual tax on investment earnings, calculated at the employee's rate, is an intriguing one. Admittedly, Professor Halperin's proposal does not mitigate the benefits derived when the employee's postretirement bracket is lower than his tax rate while working. It is, however, an effort to reduce the perceived deferral privileges of current law.

Professor Graetz, accepting the view of present law as a "massive" tax expenditure, suggests that income tax preferences ultimately are an unacceptable means of implementing national retirement policies.[87] He is particularly critical of the status quo in light of the regressive nature of social security payroll taxes. Given existing political constraints, Professor Graetz would impose a flat tax on

83. Halperin, *supra* note 81, at 521.

84. Halperin, *supra* note 81, at 521.

85. Halperin, *supra* note 81, at 523-24, 544-50.

86. Halperin, *supra* note 81, at 539, 551 n.169.

87. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 907 (1987).

the earnings of qualified plans or an excise tax on the assets held by such plans. He would use the resulting revenue to improve social security benefits "for low- and moderate-income retirees" and to lower social security taxes for "the working poor."[88]

In short, the present treatment of qualified plans has not fared well among tax commentators. At best, the status quo has won grudging acquiescence as a tax expenditure necessary to encourage retirement savings. At worst, current law has been viewed as an unacceptable deviation from the rules that ought to be used to measure a taxpayer's income. I suggest, contrary to this consensus, that existing law in its essentials is quite consistent with the principles of a normative income tax.

IV. CRITERIA FOR DETERMINING THE NORMATIVE PROPRIETY OF AN INCOME TAX PROVISION

A. *Translating an Ideal Definition of Income into a Normative Income Tax*

It is necessary at the outset to distinguish "the economic definition of income"[89] from the concept of a normative tax, the baseline from which deviations deserve to be labelled tax expenditures. Even the most stalwart advocates of tax expenditure analysis acknowledge that, for purposes of identifying a normative tax, ideal notions of income must be tempered "by reference to 'the generally accepted structure of an income tax.' "[90] As Professors Surrey and McDaniel note, translating a theoretical concept of income into a normative tax "produce[s] numerous questions of detail, some of them involving quite difficult classification questions."[91] Similarly, Professor McIntyre suggests that the classification of a particular tax provision as normative or expenditure may vary depending on the purpose for which the classification is being made.[92]

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.

In short, converting an economist's ideal of income into a normative tax requires choices among reasonable alternatives using such criteria as public acceptability, administrability, and the like. Through this process, the choices made to construct a normative income tax can quite plausibly result in the treatment of qualified plans along the essentials of current law.

Professor Bittker notes that the selections involved in constructing a nor-

88. *Id.* at 908.

89. S. SURREY & P. MCDANIEL, *supra* note 59, at 4.

90. S. SURREY & P. MCDANIEL, *supra* note 59, at 4 (quoting SECRETARY OF THE TREAS., ANN. REP. ON THE STATE OF THE FISCAL PERFORMANCES FOR FISCAL YEAR 1968, at 326 (1969)).

91. S. SURREY & P. MCDANIEL, *supra* note 59, at 5.

92. McIntyre, *supra* note 9, at 82.

mative income tax are often quite subjective and cover a wide range of possibilities. From this he concludes that the notion of a normative income tax, and the Haig-Simons definition which it implements, are not particularly useful concepts for tax policy.[93] Whether this perspective is correct, the notion of a normative income tax has become central to the tax policy debate. This Article therefore meets those opposing the current treatment of qualified plans on their own ground by assuming the propriety of seeking a normative tax.

B. *Overview of Criteria*

The defense of the status quo presented here thus begins by identifying the criteria which should be used to determine how well a particular feature fits into a normative income tax. Over the years commentators have identified a variety of considerations for analyzing existing and proposed provisions of the Code.[94] Not all commentators advance the same criteria, define them similarly, or place the same weight on each of them. Some criteria are more appropriately employed once a particular feature has been identified as a tax expenditure, rather than at the earlier stage of determining its normative propriety. The criteria that have evolved are not rigidly self-contained concepts, but tend to meld into one another. Often they conflict.[95] Indeed, a central theme of this Article is that the essentials of present law provide as reasonable a resolution of these conflicts vis-à-vis qualified plans as any of the alternatives.

In sum, subjectivity is a significant element in selecting and framing tax policy criteria, as choices among and the priority given to particular criteria reflect, *inter alia*, one's underlying views of the income tax and the society to which it applies. As in any instance when disagreements ultimately reflect differences of tastes and values, the best one can do is make explicit one's selections, provide a rationale for them, and proceed.

C. *Measurability*

A normative tax provision should permit the calculation of the taxpayer's income with reasonable accuracy. Certain events that enhance a person's economic capacity ought not to create occasions for tax because of the difficulties of quantification. Taxation in these cases should be postponed until liability can be measured properly.

As a theoretical matter, the exchange of property is an occasion for assess-

93. Bittker, *supra* note 9, at 260.

94. *See, e.g.*, H. SIMONS, FEDERAL TAX REFORM 4 (1950); *see also* D. BRADFORD, *supra* note 22, at 1-2, 21 (tax system should be equitable, easy to understand, and conducive to economy); Fox, *The Personal Income Tax as a Component of State Tax Structure*, 39 VAND. L. REV. 1081, 1083 (1986) (considering ability of tax to provide revenues, equity implications, administrative implications, and effect on economic markets); Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 567 (1965) (guidelines offered for tax systems should reflect sensitivity to society in which system will function); Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 FORDHAM L. REV. 1255, 1256-64 (1985) (criteria to be examined include simplicity, equality, fairness, neutrality, economic growth, adequacy, and compatibility).

95. *See* H. SIMONS, *supra* note 94, at 9; Sneed, *supra* note 94, at 599; Yorio, *supra* note 94, at 1264.

ing gain or loss for tax purposes.[96] As a practical matter section 1031 of the Code permits many exchanges to occur without tax because the properties involved are of a "like kind."[97] Although no explanation is completely satisfactory for section 1031, many commentators suggest that it reflects in part a decision to delay tax until property is converted to cash, thus obviating the need to value assets without readily ascertainable prices.[98]

Although Haig-Simons theoretically requires the annual valuation and taxation of unrealized appreciation, the consensus among commentators is that such a scheme is unworkable.[99] Consequently, most of the literature of tax reform supports constructive realization, which minimizes valuation problems because in lieu of repeated annual measurements, property would be valued and gain taxed only once, at death or upon gift.[100] Even those advocating the yearly taxation of unrealized appreciation generally would restrict it to bonds and securities for which market quotes or close substitutes are available.[101]

In the context of measurability concerns, consider also the problem of human capital. Should the granting to a medical student of his M.D. degree be an occasion for income tax? The degree is an intangible "accession[] to wealth,"[102] making the new doctor more capable of paying tax than his unsuccessful classmate who flunked biochemistry. Most lawyers would reply that there is no tax on the receipt of a medical degree because the new physician has yet to realize income. Although such terminology provides a convenient label for existing law, it does not really elucidate the underlying reasons why the Commissioner of Internal Revenue fails to present an assessment to the former medical student as he marches off the graduation dais.

In large part, the failure to tax the award of an M.D. degree reflects the notion that income tax should not be assessed until the physician has converted his degree into something reasonably measurable, such as cash or cash equivalents.[103] Estimating the value of a medical degree would be a difficult task, a nonproductive use of the tax collector's limited resources. Moreover, any

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96. *See* I.R.C. § 1001(a) (1982).

97. *Id.* § 1031(a) (West Supp. 1987).

98. *See* Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S.C.L. REV. 397, 407-10 (1987); Scott, *Like Kind Replacement Property: Animal, Vegetable, or Mineral?*, 23 SAN DIEGO L. REV. 1067, 1074-75 (1986).

99. *See, e.g.*, D. BRADFORD, *supra* note 22, at 5, 43. For one who departs from this consensus, see Shakow, *supra* note 80, at 1114-15.

100. *See* S. SURREY, *supra* note 60, at 199; Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, in A COMPREHENSIVE INCOME TAX BASE? 45-47 (1968); Musgrave, *In Defense of an Income Concept*, in *id.*, at 78; Pechman, *Comprehensive Income Taxation: A Comment*, in *id.*, at 84. For an interesting variation on this theme, see Stephan, *A Comment on Transfer Tax Reform*, 72 VA. L. REV. 1471 (1986). Professor Stephan argues that constructive realization should be abandoned as politically unrealistic, and that federal estate and gift taxes should be viewed as compensating mechanisms. *Id.* at 1472.

101. *See, e.g.*, Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623, 645-47 (1967).

102. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

103. A second reason we do not tax the new physician is because he may choose not to practice medicine or to practice in a fashion that does not maximize his income, e.g., by serving as a medical missionary overseas. Nontaxability thus reflects an unwillingness to interfere too deeply in the doctor's life. Burdening him with a tax liability could prohibit him from pursuing a charitable or non-

valuation of a newly awarded medical degree, necessarily predicated on averages and predictions, would be unfair in many cases. Too much income would be imputed to the physician who will work with Mother Theresa, and too little to the doctor who will become cosmetic surgeon to the stars. Measurability thus melds into two other criteria, administrability and fairness.

Measurability concerns strongly support the policies of present law as to qualified plans. Current law has the advantage of postponing taxation until cash is actually received by the employee, when valuing his benefit is no problem. Given the discrepancy between the economic expectations of plan participants and their legally accrued entitlements, as well as the inherent imprecision of actuarial methods, measurement considerations strongly militate against the taxation of accrued benefits and employer contributions under defined benefit pension plans and, to a lesser degree, in the defined contribution setting.

D. *Administrability*

A second consideration is administrability or, as Professor (now Judge) Sneed labels it, "practicality": a tax law ought to be reasonably easy for the collector to enforce and for the taxpayer to comply with. As between two otherwise equally attractive proposals, the one administratively simpler for the Internal Revenue Service (IRS) and the taxpayer is preferable.[104]

Our conception of a normative income tax has been heavily influenced by considerations of administrability. Even fervid supporters of a comprehensive tax base acknowledge that, for practical reasons, an income levy must fall short of the theoretically sweeping notion of income.[105] Thus, among most tax reformers, there is at best restrained enthusiasm for imputing to taxpayers the rental value of their homes and no support for taxing the imputed rental values of consumer durables.[106] Problems of administrability loom large in these decisions.

Similarly, few commentators advocate the taxation of accessions to human capital.[107] A significant factor behind this attitude is the difficulty for the IRS and taxpayers in administering and complying with the taxation of such capital. Again, the notion of constructive realization is illuminating: the one-time taxation of unrealized gains is administratively simpler than repeated annual valuations, particularly of nonmarketable assets.

Administrative concerns strongly support the retention of current law vis-à-

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medical career. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 STAN. L. REV. 831, 842 (1979).

104. Sneed, *supra* note 94, at 572; Rock and Shaviro, *Passive Losses and the Improvement of Net Income Measurement*, 7 VA. TAX. REV. 1, 2 (1987) ("ideal income tax" tempered by, *inter alia*, concerns of "administrability").

105. The best exploration of this issue is to be found in the essays collected in A COMPREHENSIVE INCOME TAX BASE? (1968).

106. *See, e.g.*, D. BRADFORD, *supra* note 22, at 6; R. GOODE, *supra* note 63, at 117, 139; Surrey & Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT'L TAX J. 528, 529 (1969).

107. *See, e.g.*, Goode, *supra* note 69, at 12-13.

vis qualified plans. Those advocating reform of the status quo have, in my judgment, seriously underestimated the administrative complexities of their proposals. In the defined benefit context, the taxation of accrued benefits would enmesh the IRS and employers in complex actuarial calculations. The same is true of the taxation of employer contributions in certain defined benefit settings. Taxing plan earnings at employees' marginal rates would impose on employers the burdensome task of obtaining employees' incremental brackets and calculating tax separately for each of them. Present law is far simpler administratively, delaying taxation until the employee receives cash and imposing a modified form of wage withholding at that time.

E. *Liquidity*

My third criterion is liquidity. Other circumstances being equal, a law which taxes when the taxpayer has cash is preferable to one which taxes when he does not. Both the current design of the Code and most reform proposals reflect this concern. Those advocating the annual taxation of appreciation of marketable securities do so on the ground, *inter alia*, that such securities are cash equivalents and that, consequently, the security owner could easily raise the money to pay his yearly tax liability under such a scheme. David Slawson observed that, in discussion of tax policy,

> [l]iquidity [ought to be viewed] in its broadest sense, taking into account any reasonable obstacle to converting property to cash—factual, legal or subjective. When all the barriers to conversion are low, the increased value of appreciated property is indistinguishable from cash in its effect on the owner's ability to pay, and ability to pay is the touchstone of liability for an income tax .... [P]ublicly traded stocks amply meet ... the test of liquidity .... They can be sold quickly, easily and at a known price.[108]

Similarly, Professors Surrey and McDaniel accept the rationale of section 453, which generally delays taxation under the installment method until the taxpayer actually receives cash.[109] It is consistent with normative income tax principles, they assert, to delay taxation until taxpayers "have the necessary funds with which to pay the tax."[110]

The criterion of liquidity is closely related to concerns of administrability and acceptability. Taxes levied when taxpayers have no cash will be more difficult to collect than those assessed when taxpayers have liquid assets. If a tax forces many taxpayers to confront the perceived hardship of liability without the means to pay, the tax is likely to lose legitimacy in the eyes of taxpayers.

In this vein, current law imposes tax on qualified plan participants at the time they are most liquid—when cash is actually distributed to them by the

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108. Slawson, *supra* note 101, at 625-26; *see* Blum, *Should Professionals Accept "Accrual" Fate?*, 6 VA. TAX REV. 593, 685-86 (1987).

109. I.R.C. § 453 (West Supp. 1987); *see* S. SURREY & P. MCDANIEL, *supra* note 59, at 189-90.

110. S. SURREY & P. MCDANIEL, *supra* note 59, at 189-90. However, I.R.C. § 453 has not been without its critics. *See* Blum, *supra* note 108, at 683-84; Note, *Fairness and Tax Avoidance in the Taxation of Installment Sales*, 100 HARV. L. REV. 403 (1986).

plan. In contrast, if accrued benefits or employer contributions are taxed to employees, many will have trouble paying because the accrual of benefits and the contributions of employers do not put cash into the hands of employees, and because employees are largely forbidden from borrowing against their interests in qualified plans. Although liquidity problems could be addressed by using plan resources to pay participants' taxes, that possibility raises other questions, the answers to which are unclear at best.

F. *Acceptability*

A basic concern in the design of a tax must be its acceptability to taxpayers. Tax laws viewed as oppressive or irrational will be more difficult to enforce than those perceived by the public as logical and fair. Even if the government can enforce a revenue law which taxpayers view as illegitimate, taxpayers' perception that they have been taxed improperly may affect their morale and, ultimately, their willingness to comply with other aspects of the tax system. Laws perceived to be illegitimate are not desirable in a democratic society nor are they likely to remain on the books. Revenue provisions understandable to more affluent taxpayers may be less readily accepted by those not as financially sophisticated.

Such considerations loomed large in the rhetoric and substance of the effort culminating in the Tax Reform Act of 1986.[111] In President Reagan's words, "As [taxpayer] dissatisfaction increases, the continued viability of the tax system is threatened . . . . Efforts to increase compliance within the framework of the current system . . . often seem to be counterproductive: They increase resentment and disrespect for a system that cannot long function without a firm foundation of public confidence."[112]

The present treatment of qualified plan participants corresponds to the elemental notion that income is cash. Few would question the propriety of taxing at the time a check is received by the taxpayer. In contrast, the taxation of accrued benefits or employer contributions could be viewed by many taxpayers as inappropriate because of the average person's tendency to equate income with cash in hand, not with economic accruals or employer contributions beyond his reach.

G. *Equity*

In the tradition of tax reform, the search for equity has been as central as it has been elusive. The use of income as a measure of economic capacity has fundamentally been animated by concern for fairness, the need to measure accurately taxpaying ability so as to apportion the costs of government on an equitable basis. Professors Surrey and Hellmuth indicate that equity is usually the

111. *See, e.g.*, 1 TREASURY REPORT, *supra* note 67, at 16.

112. THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 2 (1985) (emphasis omitted).

"principal criterion" for tax policy.[113] In his last work, Henry Simons similarly declared that

> [e]quity in [the] sense [of horizontal equity] must, in an advanced nation, predominate over, if not wholly override, all other objectives. We may, on occasion, scale down or restrict progression to conserve incentives; but we cannot wisely or reasonably promote enterprise, thrift, or industry by tax measures which systematically repudiate justice among persons.[114]

Those criticizing the present treatment of qualified plans invoke this venerable tradition when they argue that the status quo is unfair, taxing too lightly those who defer income via qualified plans as compared with those who do not.[115]

However, the alternatives to existing law would introduce significant inequities of their own. The most serious equitable problems would arise from the discrepancy in the defined benefit context between accrued benefits based on current earnings and long-term expectations premised upon eventual compensation. In this setting, the taxation of accrued benefits would, in some cases, impose the greatest tax burden on those participants who benefit least in the long run. As to all qualified plans, proposals for the taxation of employer contributions and accrued benefits would tax some participants on amounts neither they nor their beneficiaries will ever receive, a result most would consider unjust. With respect to the possibility of taxing plan earnings at employees' respective rates, the trade-off between the administrability of such a system and its fairness would be difficult. That trade-off would become more severe if Congress creates additional rate brackets beyond those provided for in the 1986 Act. In short, the choice is not between the alleged unfairness of current law and perfectly equitable alternatives, but between the present treatment of qualified plans and reform proposals that would introduce their own inequities.

H. *Simplicity*

My final criterion is statutory simplicity. Even before the 1986 Act, some dismissed simplicity as chimerical, a complex economy requiring complex revenue laws. The fate of the 1986 Act as a simplifying measure would tend to reinforce that perspective.[116] Nevertheless, in the context of qualified plans, simplicity deserves independent consideration. It is difficult to view the complicated statutory framework governing qualified plans as desirable. That framework is most frequently, and I conclude erroneously, defended on tax expenditure grounds.[117] If the status quo is only justified on the basis of na-

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113. Surrey & Hellmuth, *supra* note 106, at 537.

114. H. SIMONS, *supra* note 94, at 11.

115. *See supra* notes 59-88 and accompanying text.

116. *See, e.g.*, Posin, *A Case Study In Income Tax Complexity: The Type A Reorganization*, 47 OHIO ST. L.J. 627, 628 (1986).

117. I was among those confidently asserting that position. Zelinsky, *Transfer Taxation Without Transfer: Reflections on Employer-Provided Death Benefits, Section 2039, Disclaimers, New Forms of Wealth, and the Evolution of the Federal Estate Tax*, 58 TUL. L. REV. 974, 998 (1984); *see also* Vine, *Cash or Deferred Arrangements: What's the Beef? What's at Stake?*, 5 VA. TAX REV. 855, 856 (1987).

tional retirement policy, the elaborate structure of vesting, coverage, nondiscrimination, and participation rules is necessary to extend the advantages of the resulting tax expenditure as widely as possible. Hence, the promise of greater simplicity under the reform proposals: when retirement plans cease to award normatively undeserved tax benefits, Congress will no longer need to maintain the extensive statutory framework regulating those benefits.

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.

I. *Unused Criteria*

This list of criteria omits several concerns that have played a significant role in academic and political debate about tax policy. Professor Yorio, for example, advances economic neutrality, the adequacy of revenue, and economic growth among his tax policy criteria.[118] Henry Simons viewed as important the "maximum directness in federal taxation, *i.e.*, minimal concealment and fullest exposure of his actual dollar tax burdens to every individual."[119] Professor Sneed propounded as major criteria the achievement of economic stability and "a high degree of harmony between the income tax and the sought-for political order."[120] Considerations of economic efficiency have also played an important role in tax policy discussion.[121]

I eschew these additional criteria, not because they are unimportant, but because they either are unhelpful in the context of qualified plans, or are used more appropriately after a determination that present law constitutes a tax expenditure requiring further defense. Few would deny the significance of the federal government's ability to expand and contract aggregate demand in response to macroeconomic requirements. From this perspective, however, no reason exists to believe the status quo as to qualified plans is preferable to the proposed alternatives or vice versa. Similarly, neither existing law nor any suggested reform has an advantage in terms of directness. Each lends itself to full disclosure, unlike the corporate income tax whose burden cannot easily be disclosed to the taxpayer because it is subject to dispute.[122]

Consider also the related criteria of growth, neutrality, and efficiency. If

118. Yorio, *supra* note 94, at 1261-63.

119. H. SIMONS, *supra* note 94, at 7.

120. Sneed, *supra* note 94, at 568 (emphasis omitted).

121. Zelinsky, *supra* note 9, at 974.

122. R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 411-12 (4th ed. 1984).

the current treatment of qualified plans cannot be justified as part of a normative income tax, proponents of the status quo might choose to raise such economic considerations as a second line of defense. If existing law fits into a normative income tax, however, these considerations actually raise a different question: Do we want an income tax? Some oppose an income tax largely because of its economic effects. If there is to be such a levy, and if current law as to qualified plans is a normatively proper part of such a tax, these economic considerations become part of a different debate regarding the relative merits of the income and consumption bases.[123]

V. THE CURRENT TAXATION OF ACCRUED BENEFITS UNDER DEFINED BENEFIT PLANS

A. *Overview*

An analysis of the reform proposals should begin with the defined benefit pension plan, the classic and still dominant form of qualified retirement arrangement. With regard to such plans, taxing employees on accrued benefits as earned creates seven significant problems. First, as to measurability and equity, accrued benefits under such plans fail to reflect the underlying economic expectations of employer and employee. Taxing accrued benefits consequently will not lead to accurate comparisons of accretions in personal wealth and may actually have a contrary effect, taxing most heavily those who gain least in the long run from defined benefit plans. Second, assuming acceptance of accrued benefits as a measure of tax liability, valuing those benefits involves serious procedural difficulties. For tax purposes, the accurate measurement of accrued benefits would require a complex actuarial system to discount accrued benefits to their present values, a system raising important concerns of administrability. Third, interest rate changes will cause fluctuations of the present values of previously taxed accrued benefits with potentially serious consequences for taxpayer morale and equity. Fourth, taxing accrued benefits would result in taxing some defined benefit plan participants on amounts they will never receive, a possibility troublesome from the perspectives of fairness and taxpayer acceptability. Fifth, taxing employees on accrued benefits could create serious problems of liquidity, as plan participants would report such benefits as income without simultaneously receiving any cash with which to pay tax. Sixth, taxing accrued benefits would entail problems of acceptability, rank-and-file taxpayers not comprehending why they should pay tax in the absence of cash. Last, taxing employees on accrued benefits would require a substantially more complicated statutory framework than is necessary to implement the essentials of current law. On balance, one could reasonably prefer the problems and limitations of the status quo as part of a normative income tax.

123. *See* D. BRADFORD, *supra* note 22, at 36-38; Bradford, *supra* note 71, at 96.

B. *Economic Expectations Versus Accrued Benefits*

A discrepancy exists between an employee's accrued benefit[124] based on his current salary and the implicit, long-term economic expectation of the employer and the employee as to the employee's eventual retirement benefit premised on his final compensation. Accrued benefits thus understate the implied economic claims of employees against their employers.[125] Under a system taxing accrued benefits, the variance between legally accrued and economically expected benefits could lead to relatively heavy taxation of those who, as a long-term economic matter, gain least from defined benefit plans. The taxpayers most likely to be caught in this quandary are those expecting stable earnings throughout their careers who accrue pension rights comparatively early. On the other hand, upwardly mobile employees, who can anticipate substantial salary increases over their working lives, could be viewed as undertaxed pursuant to a system taxing accrued benefits. Their long-term pension expectations, premised on eventual compensation, are substantially underestimated by their legally accrued benefits; thus, their liabilities would be correspondingly understated if the Code were to tax on that basis.

Consider again a hypothetical employee who, after two years of employment, has an accrued benefit of $606. This amount represents the benefit the employee has earned under the provisions of the plan at his current compensation and service to date, the benefit to which the employee has a potential legal claim if the plan suddenly terminates or if the employee quits. However, evidence is growing that implicitly the employee has been promised by the employer a greater benefit based on his ultimate salary and that the employee has accepted a lower current wage based on the employer's implied commitment to provide this larger amount at retirement.[126]

Our hypothetical employee, it will be recalled, presently earns $20,000 yearly. That salary, if continued to retirement, will yield an eventual annual benefit of $10,000, of which the employee has earned 2/33 after two years.[127] It is likely, however, that the employee expects his salary, as a result of inflation, productivity increases, and greater seniority, to rise over the course of his working career, resulting in an increased pension. It is also likely that the employer anticipates the same. Assume the employer and employee expect the employee to be earning $50,000 yearly at retirement and thus to be entitled to a pension of

124. For a discussion of the concept of accrued benefits, see *supra* text accompanying notes 36-39.

125. R. IPPOLITO, *supra* note 10, at 36-37, 233; R. IPPOLITO, A STUDY OF THE REGULATORY IMPACT OF ERISA 32 (U.S. Dep't of Labor 1986); Ippolito, *Issues Surrounding Pension Terminations for Reversion*, 5 AM. J. TAX POL'Y 81, 83 (1986); Stein, *Raiders of the Corporate Pension Plan: The Reversion of Excess Plan Assets to the Employer*, 5 AM. J. TAX POL'Y 117, 117-18 (1986). For a journalistic presentation of these views, see Friedman, *Raiding Retirement Funds Is Piracy*, N.Y. Times, Sept. 28, 1986, § 3, at 2, col. 3 ("Companies make an implicit promise to their workers that pension plans will continue and be steadily improved . . . .").

126. Ippolito, *supra* note 125, at 83. Professors Fischel and Langbein have dissented from this line of analysis. *See* Fischel & Langbein, ERISA's Fundamental Contradiction: The Exclusive Benefit Rule (Oct. 12, 1987) (unpublished manuscript).

127. *See supra* text accompanying notes 36-39.

$25,000 annually.[128] The employer and employee expect that the employee retrospectively will have earned in the first two years $^{2}/_{33}$ of a pension of $25,000. In effect, subsequent salary increases will retroactively make the employee's first two years of pension participation more valuable than they were at the time they occurred.

It seems unexceptional that, in salary negotiations, employees receive lower current wages, all other factors held constant, for deferred compensation via qualified plan benefits. More controversially, an evolving body of economic evidence indicates that, in such negotiations, employers and employees reduce present compensation, not for legally accrued plan benefits premised on current salary, but for the eventual benefit based on the higher compensation expected at retirement.[129] Thus, our hypothetical employee has traded more in current wages than indicated by the accrued benefit under the plan. The employee's cash compensation was instead decreased by the present value of the larger pension the employee actually expects, but to which he now has no legal claim. During his second year of employment, the employee accrued an additional $303 in annual retirement benefits. However, the employee's current wages were decreased, not on the basis of that figure, but by more because the employee and employer expect a larger benefit will in fact be paid for service in that year.

If this analysis is correct, proposals to tax accrued benefits are enmeshed in an insoluble quandary in the context of defined benefit plans. The fundamental premise of such proposals is that income should be a comprehensive and accurate measure of economic capacity. However, legally accrued benefits understate the employee's actual claim against his employer, a claim for a higher pension which is expected but not yet accrued. Although that long-term claim is not yet legally enforceable, it is implicitly recognized in wage negotiations and, in the vast majority of cases, is honored because the employer, responding to competitive pressures, union power, or the force of moral commitment, continues the defined benefit plan or a close substitute for the expected increases in compensation in subsequent years.[130]

If the relevant comparison for tax policy is between an employee in a defined benefit plan and one who is not, we might nevertheless proceed with the taxation of accrued benefits based on present compensation. Even if such taxation understates the value of the employee's long-term economic pension claims, so long as something from the plan is currently taxed to that employee, he is compared more accurately against the worker who has no pension coverage at all.

Matters are more complicated, however, if the concern is the proper measurement of the relative economic positions of two employees, both in defined benefit plans. In this setting the divergence between benefits accruing legally and benefits expected economically can have perverse effects under a system tax-

128. In the example, the pension is assumed to be 50% of the employee's highest annual compensation, or $50,000.

129. R. IPPOLITO, *supra* note 10, at 42.

130. R. IPPOLITO, *supra* note 10, at 42.

ing accrued benefits when earned. It is possible that the employee with the smaller accrued benefit, and therefore less proposed income, is in fact the employee with the greater long-term pension expectancy. Consider, for example, two employees of the same age, earning the same current salary. One is a management trainee who can reliably expect his compensation and, therefore, his pension to increase dramatically in the years ahead. The other is a blue collar worker, at the top of his pay scale, who can expect relatively little in the way of future salary increments. Suppose also that the plan maintained by the trainee's employer provides a benefit of fifty percent of final earnings, while the plan in which the blue collar employee participates has a more generous formula, seventy-five percent of final salary.

The management trainee's long-term economic pension claim against his employer may well have grown more during this year than the pension claim of his blue collar counterpart, since the trainee worked one year towards a higher ultimate pension based on a substantially greater final salary. This claim, although not legally enforceable, is nevertheless one the trainee can rationally consider part of his personal portfolio. However, under a system taxing accrued benefits, the blue collar worker will pay the greater tax for this year because legally he earned a higher benefit under their respective plans. One may question whether this results in tax equity.

As a practical matter, accrued benefit taxation must be based on current salary and service, because the eventual pension implicitly promised the employee cannot be measured by the tax system with any precision or ease. However, the existence of that implied promise and the inability of the tax system to reflect it mean that accrued benefit taxation will not necessarily measure accurately the relative economic capacities of employees participating in defined benefit plans, and may inequitably impose the greatest tax burden on those employees who will benefit least from such plans in the long term.[131] Current law avoids these problems of measurability and equity by postponing taxation until the actual receipt of cash, when the discrepancy between benefits accrued and benefits expected is gone.

C. *Procedural Problems Valuing Accrued Benefits*

Despite these problems, let us assume a willingness to proceed with the taxation to defined benefit participants of their respective accrued benefits. For tax purposes, these benefits, formulated as annuity payments the employees will receive at retirement, must be discounted to their present values. Because of the nature of actuarial discounts, this process presents a serious trade-off between the accurate valuation of accrued benefits and the administrability of the tax system. Some valuation factors, in particular interest discounts and participants' life expectancies, can be handled with relative administrative ease through the promulgation by the IRS of standards applicable to all taxpayers. Others,

131. The overtaxed employees would tend to be unionized employees and civil servants, because these workers have relatively stable earnings potential and strong pension plans.

specifically the actuarial discounts relative to disability and death benefits, present more complex procedural problems because it is difficult, if not impossible, to make these adjustments in a standardized fashion.

To begin valuation, the federal government would promulgate uniform interest rates.[132] Because the Code already provides a mechanism for selecting such rates, these or similar interest rates could be used to value the accrued benefits of all plans.[133] Similarly, the IRS could adopt one of the widely used mortality tables and require its use to determine employees' life expectancies and thus the number of years their annuities can be expected to run.[134]

Consider, however, the troubles posed by the phenomenon actuaries label "the decrement for disability," the need to adjust for the possibility of employee disability prior to retirement. To value accrued benefits accurately, we must adjust for the possibility that, because of disability, employees will receive benefits early or will receive benefits to which they would not otherwise become entitled. Let us initially assume a defined benefit arrangement under which an unvested employee, disabled before retirement, vests and immediately receives his entire interest in the plan. If vested prior to disability, a disabled employee receives his interest at once. The tax system could ignore these contingencies and decline to value the employee's accrued benefit in light of his disability coverage. That choice, however, is unsatisfactory when contrasted against another employee whose plan fails to provide such coverage. The former employee earns something more valuable when he accrues benefits under his plan.

However, valuing disability benefits is easier said than done. No disability tables are universally accepted like the widely used mortality charts. The odds of an employee becoming disabled will thus be calculated differently depending on the particular actuary's selection of the population reflecting the employee's likelihood of disability.[135] Moreover, different plans have different standards for disability and pay different levels of disability benefits. Disability may mean

132. An alternative discount factor is the interest rate used by the plan for funding purposes. If the plan's actuaries assume the plan's investments will earn a 6% return, the employee could discount his increased accrued benefit at 6% and report the resulting present value as current income. Ultimately, however, it is not desirable to use each plan's own interest rate, because such an approach would create inequities among similarly situated workers. Such an approach would also work a perverse effect on funding policies.

To continue our example, suppose a second, otherwise identically placed worker, accrued the same benefit under a plan assuming an 8% interest rate. If this second employee is allowed to discount his accrued benefit by his plan's assumed rate of 8%, he will report less current income than the worker required to value his identical entitlement at 6%. To lower his taxes, the first employee may ask his employer to increase the plan's assumed interest rate to 8%. The employer might be only too happy to comply; higher interest rate assumptions allow the employer to contribute less currently because of greater assumed future earnings. A tax system that encourages employees to seek decreased employer contributions is somewhat troubling.

Professor Shakow would value accrued benefits using the plan's actuarial assumptions. Shakow, *supra* note 80, at 1138. Although that proposal eliminates the need for the IRS to promulgate actuarial factors, it does create the possibility of discrepant treatment of identical benefits, because plans can use different assumptions.

133. I.R.C. § 1274(d) (West Supp. 1987).

134. G. GILBERT, G. LACHOWICZ & J. ZID, *supra* note 24, at 7-3 to -4; D. MCGILL, *supra* note 22, at 245-48; D. MCGINN, *supra* note 24, at 26-27.

135. D. MCGINN, *supra* note 24, at 28.

an employee's inability to perform any work, an inability to perform any work for that particular employer, an inability to perform the same job that the employee held at the time of disability, or any other imaginable standard. Disability may mean a permanent or temporary condition, or a total or partial state. The level of disability benefits may range from nothing, to benefits vested at the time of disability, to some percentage of accrued benefits, or to all accrued benefits. Such benefits may commence immediately on disability, after a specified time has elapsed, at a particular age subsequent to disability, or after alternative sources of income, such as workers' compensation, have been exhausted. Disability benefits may be reduced by the amount of those alternative sources or by some percentage of them.[136]

If federally mandated disability discounts[137] are promulgated in a simplified fashion ignoring these difficulties, the taxation of accrued benefits will be more easily but less accurately implemented, standardized assumptions being less precise than carefully tailored actuarial analyses. As the IRS goes deeper into the business of actuarial assessments of particular disability likelihoods, standards, and benefits, valuation will be more accurate but the system will become less administrable.

Similar considerations arise with respect to the need to account for plans' differing death benefits. Defined benefit plans need not provide death benefits for unmarried participants or for participants married less than twelve months.[138] The legally required payment for a surviving spouse need not constitute the deceased participant's entire interest in the plan.[139] Death benefit provisions may thus range from no benefit for the unmarried, to the legally mandated minimum for spouses, to a full death payment disbursing the employee's entire interest in the plan regardless of marital status.

Assume that an employee is single and that the plan in which he participates does not provide death benefits for unmarried employees. When the employee accrues a benefit, it must be discounted for the possibilities raised by the employee's death in order to determine the present value of that benefit. Failure to make this discount overvalues the employee's benefit accrual vis-à-vis an otherwise similarly situated worker whose plan does provide death benefits to unmarried participants. In short, it would be necessary under a system taxing accrued benefits to classify plans by the generosity of their death benefits and appropriately discount in light of taxpayers' mortality possibilities. Given the range of potential death benefits, the resulting valuation system would be complicated, presenting again a trade-off between administrability and accuracy. As to both disability and death benefits, current law avoids this trade-off by delaying income taxation until benefits have been converted to actual cash in the hands of the participant or beneficiary.

136. D. McGill, *supra* note 22, at 160-63; D. McGinn, *supra* note 24, at 16, 28.

137. The alternative—allowing employers to specify the disability discount—again gives the employer the right to decide how much income tax his employees will pay.

138. I.R.C. §§ 411(a)(3)(A), 417(d) (1982 & Supp. 1985).

139. *Id.* § 417(b)-(c) (West Supp. 1987).

D. *Valuation Fluctuations*

Repeated fluctuations in the value of previously taxed benefits would pose important issues of fairness and acceptability for the taxation of accrued benefits under defined benefit plans. Suppose the interest rate promulgated by the IRS for discounting accrued benefits is initially six percent. Our hypothetical employee would report $410.52 income in his first year, the actuarial present value of $303 annually starting at age sixty-five discounted at six percent per annum.[140] In his second year, the employee would recognize income of $459.78. Of this amount, $435.15 would represent his second $303 accrued benefit discounted to its current actuarial value at a six percent rate.[141] The balance would reflect the increased present value of the benefit earned the year before, now worth more since it would be one year closer to commencing.[142] Suppose, at the beginning of the third year, the interest rate rises to nine percent. The combined present value of the employee's first two years' accrued benefits would drop to $356.30, reflecting the decreased value of a fixed stream of income when interest rates increase.[143] The employee would have thus reported income of $870.20,[144] although the stream of pension payments he has accrued is now worth less than half that amount. The premises of the reform proposals imply that the employee would be entitled to a deduction because an increased discount factor has depressed the current value of his accrued benefit. Moreover, when interest rates fall again, the employee would recognize income on the recovery of the value of his accrued benefit.

Given the many years between the accrual of his initial entitlement and its receipt at retirement, the employee would likely report income and take losses on the same benefit stream many times as interest rates rise and fall. Some may, with equanimity, simply view this as Haig-Simons at work. A contrary view is that the average taxpayer would be confused by a pattern of successive gains and losses on the same pension benefit. Taxpayer morale is no minor consideration in a system based on self-assessment.

To simplify matters for the average taxpayer, the Code could disallow losses to the value of previously taxed pension rights and defer further income until the present value of the employee's accrued benefit returns to the total on which tax has already been paid. Suppose our hypothetical employee accrues another $303 benefit in his third year. His entire accrued benefit of $909 would

140. The calculations used here are simplified to highlight the effects of fluctuating interest rates. They ignore the possibility of preretirement death, disability, or termination of employment. Similarly, the calculations ignore the value of postretirement death benefits. I have assumed that the employee will retire at age 65, when the plan will need $9.268 for each $1.00 in annual pension benefits owed the employee. The $9.268 rate is the one used by Professor McGill. D. McGILL, *supra* note 22, at 275. Thus, when the employee is 65, the plan will require $2,808.20 to provide $303 yearly for the rest of the employee's life (*i.e.*, $303 × 9.268 = $2,808.20). The amount of $2,808.20 discounted by 33 years at 6% yields a present value of $410.52.

141. Discounted for 32 years at 6%, $2,808.20 yields a present value of $435.15.

142. Six percent growth on $410.52 is $24.63.

143. At age 65, the employee's total benefit of $606 will require $2,808.20 multiplied by two, or $5,616.40. Discounted at 9% for 32 years, $5,616.40 yields a total of $356.30.

144. Total income recognized is derived as follows: earnings of $410.52 in the first year plus $459.78 in the second.

have an actuarial present value at nine percent of $582.54.[145] The prior taxation of $870.30 could be viewed as a prepayment, delaying additional tax until the present value of all accrued benefits again equals $870.30.

Although this approach is in some respects a more practical system than one recognizing successive losses and gains on the same stream of retirement payments, it seems a crude and unfair measure of taxpaying capacity. Contrast our hypothetical employee under this alternative with one the same age who accrues his entire benefit of $909 after the interest rate has risen to nine percent. This second employee would simply pay tax on the actuarial present value of $582.54—not an equitable result vis-à-vis his counterpart, who has the same accrued benefit but has included in his income a larger amount because interest rates were lower when the counterpart accrued his benefits. Present law avoids all of these problems by taxing only when the value of pension participation is finally fixed and the benefit is reduced to cash in the employee's possession.

E. *Taxing Employees on Benefits They May Never Receive: Death and Insolvency*

Taxing employees on accrued benefits implies taxing some of them on amounts they will never receive. Ultimately, the taxation of accrued benefits is the taxation of actuarial averages. By definition the experience of some taxpayers will differ from that predicted for them. Consider an employee who dies the day after his retirement, never receiving a payment from the plan because of his early demise. Under a system taxing accrued benefits, the employee will have incurred plan-based taxes throughout his career even though, in the end, the employee will actually be paid nothing by the plan.

Some will not be troubled by this, or the more common case of a retiree receiving comparatively modest benefits before death. In this view, a defined benefit plan is the mirror image of an employer-provided insurance policy, a valuable service received during the employee's lifetime that only pays on the contingency of his continued life. The possibility that the employee would die before the end of his normal life span was reflected in the mortality discount used to value the benefits he accrued during his working career.

The analogy is, however, unsatisfactory. Pensions are not understood by employers, employees, or Congress to be like insurance policies. Rather, the contemporary understanding and legal status of a pension is of deferred compensation, something the employee has earned as wages and to which he is entitled.[146] Indeed, under a system taxing accrued benefits, the prematurely deceased employee will have declared as income substantial amounts reflecting the likelihood he would live.

Richard Goode, Emil Sunley, and Professor Wolk would address the problem of benefits taxed but not received by taxing the employee only when he is

145. To provide a benefit of $909 yearly starting at age 65, the plan would need $909 times 9.268, or $8,424.61. This amount, discounted for 31 years at 9%, yields a present value of $582.54.

146. *See* 29 U.S.C. § 1001(a) (1982).

vested.[147] Under this approach, if an employee is one hundred percent vested, he would recognize income on benefits as they accrue. If the employee is less than fully vested, he would declare as income the portion of his accrued benefit to which he has a nonforfeitable right. When his vested percentage increases, the employee would then recognize as income his newly vested but previously accrued benefits. This approach is not a satisfactory response to the problem of taxing employees on amounts they may not receive. Limiting taxation to vested accrued benefits does not preclude the possibility that an employee will die before receiving the amount on which he was previously taxed. Even a vested employee must be alive to receive his benefit.

Consider the unmarried vested participant who dies while employed. Suppose that his plan has no death benefit for single participants.[148] Given the taxation of accrued benefits, the employee will have paid tax during his lifetime on amounts that neither he nor any of his beneficiaries will receive. Similarly, the vested married participant in a plan providing the legally required minimum death benefit for spouses will likely have paid tax while alive on more money than his spouse will receive.[149] In the interests of fairness, the Code would need to provide some retroactive recognition of these amounts taxed earlier but never received. This retroactive remedy, however, begs the basic question: Why tax employees in the first place on benefits they might never receive?[150]

If there is to be ex post relief for benefits accrued and taxed but not received, the mechanism implementing that relief will be complex. It would be ideal to reopen all of the participant's returns, recalculate his income for each year in light of the accrued benefits known to have been improperly included in income, and refund taxes plus interest. To the extent that this approach is approximated by a simplified formula, we confront again the pervasive trade-off between accuracy and fairness, on the one hand, and practicality, on the other.[151]

Although early death is the most obvious instance of a vested employee not receiving benefits previously accrued by him, a vested employee can live and still not be paid his "nonforfeitable" benefit because of malfeasance or maladministration by plan fiduciaries. "Vesting" is a term of art meaning less than one might assume. If the employee is a participant in a multiemployer plan, the plan

147. *See supra* notes 63-79 and accompanying text.

148. Qualified plans need not provide death benefits for unmarried participants. I.R.C. §§ 401(a)(11), 411(a)(3)(A), 417 (West Supp. 1987).

149. A spousal death benefit can be less in value than the deceased participant's entire interest in the plan. *Id.* § 417(b)-(c).

150. It is not clear how the opposite problem would be dealt with under a system of accrued benefit taxation, *i.e.*, the participant who lives longer than anticipated. Possibly the participant, having paid tax on his accrued benefit once, will not pay further tax regardless of how much he actually receives from his qualified plan. More likely, once the participant has received amounts that equal the total on which he has been previously taxed, he will report his actual payments as income. Ironically, at this point, the system taxing accrued benefits would be forced to resort to the current system, taxing employees on the sums actually received from qualified plans.

151. I.R.C. § 72(b)(3) (1982) provides for a deduction of all "unrecovered investment" in annuity contracts on the last tax return of a deceased annuitant. An equivalent deduction on the deceased participant's last return is obviously a crude remedy, ignoring the time value of the taxes erroneously paid by the participant on his accrued benefit during his life.

can decline to pay his vested benefit under certain conditions of financial stress.[152] Consider also the following scenario: Unscrupulous investors acquire a company, appoint themselves trustees of its pension assets, and plunder the firm and the plan's investments. When the investors finally are caught, the company and the plan are bankrupt. The vested employee will not be consoled by the jail terms meted out to those absconding with his retirement resources. Under these circumstances, recourse to the company will be as futile as recourse to the plan because neither will have the capacity to pay the employee's "nonforfeitable" benefit. Perhaps money can be recovered from the trustees personally[153] and the insurer that bonded them.[154] However, the ultimate guarantor of vested benefits in this situation will be the PBGC, assuming the plan is covered by its insurance program.

The PBGC is not without its own financial problems.[155] Granting its ability to make good on its commitments, the PBGC insures only minimum benefits.[156] In the dismal situation portrayed here, vested benefits above the PBGC-insured level are not likely to be paid in full even though they are "nonforfeitable" and, under a system of accrued benefit taxation, would have been reported earlier in the employee's income.

Although an extreme case,[157] this scenario fairly highlights the problem of taxing participants before they actually receive distributions from the plan. Poor investment performance combined with employer insolvency could create such situations even without felonious behavior.

In sum, under a system taxing accrued benefits, some employees will be taxed on amounts they will not receive because they will die before predicted or because of plan insolvency. Although deductions can be provided ex post for amounts accrued and taxed but never received, one can reasonably prefer the approach of the status quo, deferring tax until benefits are actually paid to the participant or his beneficiary.

F. *Liquidity*

As to liquidity, current law is at least as attractive as taxing accrued benefits and is preferable from a traditional viewpoint. An accrued benefit looks like a promissory note, embodying the plan's commitment to pay cash at a later date upon retirement, disability, or death. Under section 453 of the Code, absent a contrary election, for most taxpayers the event triggering taxation is the subsequent receipt of cash, not the prior acceptance of a note.[158] This reflects the traditional view of liquidity that looks, not to the taxpayer's total cash resources,

152. *Id.* § 411(a)(3)(F) (West Supp. 1987).

153. 29 U.S.C. § 1109(a) (1982).

154. *Id.* § 1112.

155. *See, e.g., Pickle Resolves to End PBGC Woes*, PENSIONS & INVESTMENT AGE, July 7, 1986, at 23, 23; *PBGC's Viability in Question*, PENSIONS & INVESTMENT AGE, June 23, 1986, at 10, 10.

156. 29 U.S.C. § 1322 (1982).

157. This scenario is not as rare as one would like to believe. *See* Schwartz, *Non-Fiduciary Liability Under The Employee Retirement Income Security Act*, 69 MARQ. L. REV. 561, 561 (1986).

158. *See* I.R.C. § 453 (West Supp. 1987).

but only to the particular event potentially causing taxation, the note itself. Such a view suggests the superiority of the status quo which taxes on actual distribution when the participant has cash from the plan to pay his taxes. In contrast, the accrual of benefits generates no liquid asset with which to pay tax.

As Emil Sunley has pointed out, however, the participant in a qualified plan does have liquid resources to pay tax in the form of his current compensation.[159] Wage withholding could be adapted to withdraw from employees' current salaries an additional amount for taxes on that period's accrued benefit. If liquidity is to be assessed on the basis of the taxpayer's total cash resources, Sunley's proposal to withhold additional amounts from participant's wages is unobjectionable. Indeed, when revising section 453 in 1986, Congress took tentative steps toward this broader view of liquidity, denying installment taxation when the presence of marketable property indicates the ready availability of liquid assets to pay tax[160] and when certain unrelated debt is deemed evidence of liquidity.[161] Under this broader view of liquidity, looking to the taxpayer's total resources, current law and the taxation of accrued benefits are equally attractive. In the former setting the distribution itself is available to pay tax while in the latter the employees' current wages may be used.

A further possibility has received little attention by those advocating change of the status quo: employees' taxes could be paid by the plan as a form of withholding for employees. Each plan would send an amount for each participant to the IRS, which would be credited against the employee's personal liability.[162]

One must question, however, whether the full ramifications of this possibility are discernible or desirable. Presumably, plan benefits would be reduced under this alternative, as plans would have less assets to distribute to participants and their beneficiaries after forwarding funds to the IRS. This result could affect low-paid employees adversely. Consider the plan that reduces all participants' benefits by the same percentage because it anticipates lower resources as a result of withholding taxes for employees. Some of the employees receiving reduced benefits may be low-income persons who do not owe federal tax, but who would be earning smaller retirement benefits because their plan is paying taxes owed by their more affluent colleagues. Perhaps the refund of withheld taxes not ultimately owed by low-income employees will compensate for the diminishment of their retirement payments, but it may not. Before adopting a system by which defined benefit plans pay participants' taxes, we would need to better understand the ultimate incidence of such an approach.

In sum, as to liquidity, present law is at least as attractive as taxing accrued

159. Sunley, *supra* note 74, at 82 n.11.

160. I.R.C. § 453(j)(2) (West Supp. 1987). This provision should have been designated § 453(k)(2). *See* Roche, *Installment Reporting After The Tax Reform Act of 1986*, 66 J. TAX'N 80, 80 (1987).

161. I.R.C. § 453C (West Supp. 1987), *repealed by* § 10202(a)(1) of the Omnibus Budget Reconciliation Act of 1987.

162. To the best of my knowledge, only Professor Wolk has alluded to this possibility. *See* Wolk, *supra* note 77, at 469.

benefits, because plan distributions represent liquid assets available to pay tax. If liquidity is defined in its traditional and restrictive manner, the postponement of taxation until the distribution of plan benefits is preferable to taxing accrued benefits. The accrual of benefits does not itself generate liquid assets with which to pay tax, and it is questionable whether the plan is a desirable source for tax payments.

G. *Acceptability*

Related to concerns about liquidity are concerns about acceptability. The rank-and-file taxpayer tends to equate income with cash, not with economic accruals beyond his present grasp.[163] Under a system taxing accrued benefits, many taxpayers would think they have been taxed prematurely, because they would owe tax before having received cash from their defined benefit pension plans.

Such problems of acceptability would be greater for the taxation of accrued benefits than under either a system taxing unrealized appreciation or a scheme of constructive realization. Most proponents of the taxation of unrealized appreciation would limit such taxation to publicly traded stocks and bonds.[164] I suspect the segment of the population affected by such a proposal would be relatively small, relatively affluent, and relatively sophisticated. On the other hand, given the widespread coverage of qualified plans, taxation of accrued benefits would apply to a great many average taxpayers who would be less likely to appreciate the economic significance of accruals not involving cash.

As for constructive realization, taxpayers making gifts of appreciated property and thus subject to constructive realization are, on balance, also likely to be the more affluent constituents of the tax system. Moreover, taxpayers have been trained to accept that death and gifts are occasions for taxation. In contrast, many taxpayers will find it strange, and probably unfair, to be taxed on pension accruals.

H. *Simplicity*

The status quo comes out surprisingly well under the criterion of simplicity. A statute taxing accrued benefits would not be a model of elegance. Such a statute would address such complex matters as valuing disability and death benefits,[165] valuation fluctuations,[166] and refunds of taxes on benefits accrued by taxpayers but never received by them.[167] If these issues are addressed in a simplified fashion, other concerns, such as fairness among taxpayers and accurate measurement of benefits, will be sacrificed in the search for a pristine statute.

Moreover, the relevant comparison is between a statute taxing accrued ben-

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163. D. BRADFORD, *supra* note 22, at 21; 2 TREASURY REPORT, *supra* note 67, at 129.
164. *See, e.g.*, Slawson, *supra* note 101, at 624.
165. *See supra* text accompanying notes 132-39.
166. *See supra* text accompanying notes 140-45.
167. *See supra* text accompanying notes 146-57.

efits and the principles of current law when properly understood and implemented. The essentials of present law could be embodied in a statute far simpler than the existing qualified plan provisions. Much of the complexity of the existing statute stems from provisions that are peripheral to the basic policies defended here, or that reflect the erroneous belief that present law constitutes a tax expenditure necessarily controlled through an elaborate statutory framework.

For example, section 402 prescribes the treatment of plan distributions. The essential mandate of this provision is quite direct: tax distributions in excess of employee contributions when such distributions are made. The complexity of section 402 stems largely from the pursuit of policies extraneous to this uncomplicated mandate, for example, the detailed provisions permitting the taxation of large distributions under an averaging formula.[168] That portion of section 402 simply does not belong there. If the Code should provide special tax rates for large and unusual amounts of income, no reason exists for separate treatment of large and unusual pension distributions. If the Code ought not provide special rates for abnormal income outside the qualified plan context, providing such rates for qualified plan distributions is unnecessary.[169] Either way, the complexity of the present statute is not chargeable to the essential policies of the status quo as to pension plans.

Similarly, section 402 could be stripped of its complicated provisions relative to tax-free rollovers[170] without damage to the basic policies defended here: employer deduction at the time of contribution, employee taxation upon actual distribution, and tax-free accumulation in between. As a matter of national retirement policy, Congress may want to permit the tax-free transfer of plan distributions to individual retirement accounts. If Congress chooses to delay tax to a time after distribution in this fashion, the resulting statutory complexity should not be attributed to the policy of taxing at distribution rather than earlier.

As to the complicated statutory framework relative to discrimination, participation, and coverage, it is not clear that Congress would scrap these provisions even if it taxed accrued benefits. In any event, these rules reflect the erroneous assumption that current law embodies a tax expenditure which must be spread among rank-and-file taxpayers. Once the basics of current law are recognized as a proper part of a normative income tax, these expenditure-related rules become expendable.

In short, taxing accrued benefits would not necessarily simplify the Code, because such taxation would introduce new and difficult issues that the statute would be required to address. As the essential current policies of the Code could be embodied in a simpler statute than now exists, a desire to simplify the statute could plausibly lead to a preference for the status quo.

168. I.R.C. § 402(e) (West Supp. 1987).

169. Indeed, Congress abolished the Code's general income averaging provisions in the 1986 Act. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 141, 100 Stat. 2085, 2117 (1986).

170. I.R.C. § 402(a)(5)-(7) (West Supp. 1987).

I. *Summary*

Current law vis-à-vis defined benefit plans is not perfect. Perfection, however, is not the burden borne by those defending the status quo. The taxation of accrued benefits is not a flawless alternative. The relevant inquiry is whether the attractions and disadvantages of present law, on balance, can reasonably be preferred to the advantages and problems of taxing accrued benefits. Either approach involves trade-offs and conflicts. After examining the implications of accrued benefit taxation in the context of defined benefit plans, one concerned with proper valuation, equity among taxpayers, taxpayer liquidity, statutory simplicity, administrability, and taxpayer acceptability could plausibly prefer current law as a normative tax provision.

VI. THE CURRENT TAXATION OF EMPLOYER CONTRIBUTIONS UNDER DEFINED BENEFIT PLANS

A. *Overview*

Although Haig-Simons is thought by some to mandate the taxation of accrued benefits, Richard Goode, Emil Sunley, and Professor Wolk suggest instead that the government should tax employer contributions to qualified plan participants at the time such contributions are made.[171] Administratively, this approach is preferable to the taxation of accrued benefits, because it would involve no need for detailed actuarial policing by the IRS. The taxation of employer contributions is also preferable to taxing accrued benefits, because valuation fluctuations could be presented in a fashion more likely to be acceptable to the average taxpayer. However, the taxation of contributions, like the taxation of accrued benefits, is enmeshed in equitable and measurement problems, including the conundrum that legally acquired pension benefits diverge from economically expected ones. The taxation of employer contributions could impose the heaviest burden on those enjoying the least long-term benefits from qualified plans. Taxing employer contributions raises again the problems of taxing employees on amounts they may never receive, taxpayer liquidity, taxpayer acceptability, and, to a lesser degree, statutory complexity. Finally, taxing employer contributions presents a fairness and measurement issue all its own: from an actuarial perspective, an employer may contribute to an employee's benefit after the employee has received it, leading to some anomalous results if the Code taxes employer contributions at the time they are made. On balance, the status quo again emerges as a plausibly preferable provision of a normative income tax.

B. *The Unit Credit Method*

1. Generally

The unit credit method of funding defined benefit pensions presents the strongest case for taxing employer contributions to participants at the time such

171. *See supra* text accompanying notes 63-79.

contributions are made. Under this funding method, the employer contributes annually the actuarially determined present value of the benefits accrued by each participant in that year. Consider again an employee who accrues an additional $303 payable annually starting at retirement. The plan's actuary, selecting interest rate, disability, mortality, and withdrawal assumptions, will advise the employer that the employer must now contribute a certain amount to the plan to satisfy this obligation. If the actuary's assumptions are realized, this contributed amount will grow to the amount necessary to provide the employee $303 yearly, commencing at the retirement age of the plan.[172]

If employer contributions under the unit credit method are taxed to the employee, the IRS need not involve itself in the administrative problem of valuing each taxpayer's individual accrued benefit.[173] The employee would simply report as income the dollar amount contributed on his behalf plus earnings on prior contributions. The actuarial calculations determining these sums would not be of consequence, because employees would be taxed, not on actuarial calculations, but on the actual market values of stocks, bonds, cash, and other assets funding their respective benefits.

Employees might more easily accept valuation fluctuations under a system taxing employer contributions than if the federal government taxed accrued benefits. The employee could be informed each year of the value of the pool of resources standing behind his pension. The employee would report as income or deduct as loss the difference from the pool's value in the previous year. Such differences, similar to commonly observed fluctuations in personal portfolios, might be more easily accepted as a basis for taxation by plan participants than fluctuations in the values of deferred income streams which themselves stay the same. Thus, as to administrability and acceptability, taxing contributions is preferable to taxing accrued benefits, and therefore more competitive with current law.

2. Replaying Some Themes: Fairness and Accurate Measurement

There is, nonetheless, a strong argument that employer contributions are neither fair nor accurate indicators of participants' pension-based wealth increments. Consider initially two comparisons: employees with equal accrued benefits but different contributions, and employees with varying benefits but the same contributions.

In the first case, different actuaries can suggest divergent assumptions that would lead to different contributions for identical benefits. Suppose one plan's actuary predicts lower interest rates than does his colleague. The employer using this actuary will make larger contributions to its plan, because less investment growth is anticipated prior to employees' retirements. Employees accruing

172. G. GILBERT, G. LACHOWICZ & J. ZID, *supra* note 24, at 8-2 to -5; D. MCGILL, *supra* note 22, at 272-75; D. MCGINN, *supra* note 24, at 33-37.

173. As under current law, the IRS would remain interested in the reasonableness of actuarial assumptions as they would affect employer deductions. I.R.C. §§ 404, 6659A (West Supp. 1987); *see, e.g.*, Tech. Adv. Mem. 8,604,001 (Sept. 9, 1985).

the same benefits in different plans may thus be taxed on differing contributions, depending on actuaries' varying estimates of the amounts needed to fund the benefits provided by their respective employers.

One might conclude that employees for whom greater contributions are made ought to pay greater taxes because their benefits are better funded and therefore worth more. Although this is not an implausible position, neither is it an impregnable one. Employees have no direct relationship with or legal right to employer contributions or plan assets. Their legal entitlements are to accrued benefits, not the underlying plan resources that fund those benefits.[174] One might just as plausibly decide that taxing contributions is inequitable: it leads to taxing employees with the same benefits differently, merely because their respective employers fund at divergent rates.

Consider also the possibility that employees with different accrued benefits could be allocated the same contribution. Assume that two employees of the same age participate in their respective employers' defined benefit pension plans, which are funded on a unit credit basis. One employee accrues during the year a benefit of $333, the other $300. Suppose that the actuary guiding the first plan projects higher interest rates and thus calculates a lower required employer contribution. Consequently, contributions for the two employees are the same despite their differing accrued benefits. Under a system taxing contributions, the identical contributions would lead to equal tax burdens for the two employees, despite their divergent accrued benefits. Some may view this as a fair and accurate outcome, but others may be troubled by this result.

The taxation of employer contributions is also haunted by the conundrum that what occurs legally under unit credit funding is not what occurs economically. The unit credit method funds the pension benefit accrued in that year, assuming continuation of the employee's current compensation. As we have seen, the accrued benefit may understate the amount the employee is effectively earning via the pension, because both employer and employee anticipate a higher salary and hence a greater pension in the future.[175] This year's contribution under unit credit funding, tied to legally accrued benefits at current salary, is as poor an indication of the economics of the plan as the accrued benefit itself.

Consider again a blue collar worker and management trainee, both of whom are the same age and earn the same wages. Assume both their employers maintain a defined benefit plan that promises an annuity at retirement equal to fifty percent of the employee's final salary. The blue-collar worker is already at the top of his pay scale, but the trainee has just begun his ascent to management-level compensation. The actuaries for both plans use the same assumptions. Both plans fund under the unit credit method.

The two employees will accrue the same benefit during the current year, having earned identical salaries under plans using the same benefit formula. Moreover, given the identity of the actuarial assumptions, the employees will

174. *See* 29 U.S.C. § 1053 (Supp. III 1985).

175. *See supra* text accompanying notes 125-31.

have identical contributions made on their behalf and will recognize the same income from pension participation. Economically, however, the management trainee's pension-based net worth has grown by more because he earned one year's credit towards a substantially higher eventual benefit.

Taxing employer contributions under unit credit funding would thus impose a heavier burden on those employees who, because of their limited potential for increased compensation, gain less from the pension in which they participate than those who can reasonably expect significantly higher remuneration later. As to those upwardly mobile employees, employer contributions under the unit credit method, tied to legally accrued benefits at current compensation, understate the value of their pension participation just as their accrued benefits do. Present law, by postponing taxation until distribution, avoids these valuation paradoxes and inequities, and is therefore plausibly preferable to taxing employer contributions.

3. Taxing Employees on Contributions They May Never Receive

Another fairness problem the taxing of contributions shares with the taxation of accrued benefits is that employees would report as income contributions they will never receive. Consider an unmarried, vested participant who reports unit credit contributions as income while working, but who dies before receiving any distribution from the plan. Suppose the plan provides no death benefit in the absence of a surviving spouse. Upon the participant's death, the contributions on which he paid tax will be used to provide benefits for others. Alternatively, assume the participant is survived by a spouse, but the plan provides only the minimum, legally required death benefit. In this case, much of the contributions on which the participant paid tax will never reach his surviving spouse, but will instead be used by the plan for others.

In these instances, as with the taxation of accrued benefits, the law could provide some type of ex post adjustment, such as reopening the participant's prior returns. The particular response adopted is less important than the existence of this problem: Why was the participant taxed on contributions when there was the possibility neither he nor his beneficiaries would receive them? Present law avoids this problem by deferring tax until benefits are in the hands of the participant or his beneficiary.

4. Liquidity, Acceptability, and Complexity

As to liquidity, the taxation of contributions under unit credit funding raises the same issues as taxing accrued benefits. Contributions are made for some participants decades before the participants receive distributions, yet, under a system taxing contributions, taxes would be due immediately. There is a significant liquidity problem in imposing liability on employees for contributions they have not received. The possible responses—withholding from participants' current compensation or withholding payments by the plan itself—raise trouble-

some problems.[176]

Similarly, as to taxpayer acceptability, taxing contributions under unit credit funding involves the same considerations as the taxation of accrued benefits. Because rank-and-file taxpayers equate taxability with cash in hand, they would be inclined to believe they are being taxed prematurely under a regime taxing employer contributions.

A statute implementing the taxation of contributions would be simpler than one taxing accrued benefits, because a major source of complexity, regulating actuarial valuations, is not necessary when liability is based on contributions. However, a statute implementing such taxation would include a response to the problem of contributions taxed but not received. The result could be a statute equally as or more complex than the provisions necessary to capture the essentials of current law.

5. Contributions After the Commencement of Benefits

One measurement and equity problem is unique to the taxation of employer contributions. Employers frequently contribute to defined benefit plans for employees after employees have begun receiving distributions. This would cause anomalous results under a system that taxes contributions.

Consider the phenomenon commonly called past service liability.[177] When a defined benefit plan is established, employees often receive credit for pension purposes for years of service prior to the institution of the plan. Assume an employee, on the job for twenty years, is age sixty when his employer establishes a defined benefit plan with retirement at age sixty-five. During the initial five years of the plan, the employer, under the unit credit method, will fund the benefit accrued during each year. However, much of the employee's final benefit is attributable to the twenty years prior to the creation of the plan. Funding this obligation immediately could produce a liquidity problem for the employer. Consequently, an accepted technique determines actuarially the funds that would have existed for the employee if the plan had been started at the beginning of his career. This past service liability may then be contributed by the employer over a period as long as thirty years.[178]

When the employee retires at age sixty-five, he will begin to receive his benefit even though funding of that benefit, through liquidation of the past service liability, might continue for another twenty-five years. Suppose the employee receives a lump sum upon retirement equal to the discounted present value of the annuity payments to which he is entitled. The pool of pension assets would be invaded to provide this lump sum and would subsequently be replenished by the contribution of the past service liability, a contribution probably not completed until after the employee's death.

176. *See supra* text accompanying notes 110-11.

177. G. GILBERT, G. LACHOWICZ & J. ZID, *supra* note 24, at 5-13 to -18; D. MCGILL, *supra* note 22, at 264; D. MCGINN, *supra* note 24, at 13-18.

178. I.R.C. § 412(b)(2)(B) (1982).

The past service liability result indicates the fallibility of taxing employer contributions. When such liability exists, present law frequently taxes the employee on his benefit earlier—for example, on distribution of a lump sum—than would taxing at the time of contribution. The Code could tax at the earlier of two events, the employer's contribution or the distribution to the employee. There is, however, no rationale for such an approach other than the desire to impose liability on the participant at the earliest possible moment. This takes us far from the ethical considerations animating Haig-Simons.

Consider also what actuaries call experience losses.[179] An experience loss is not a loss as understood by lawyers and economists, an absolute decline in the real or nominal value of an asset. Rather, it is a discrepancy between the actuary's assumptions for the plan and the plan's actual performance. Suppose the actuary predicts an interest rate of eight percent, but the plan subsequently earns six percent. In absolute terms, the plan has had a gain of six percent. However, from an actuarial perspective, the plan has suffered a loss because it has earned interest at a rate two percent lower than predicted. This deficiency must be made up to restore the plan to actuarial soundness. In the next year, the employer can augment his contribution with an amount equal to the earnings shortfall from the prior period. More commonly, the shortfall will be liquidated in annual installments over a period that can be as great as fifteen years.[180]

Assume an employee is near retirement when economic conditions deteriorate. Consequently, the plan has experience losses due to a poor economy that yielded less-than-expected investment growth. When the employee retires and begins to receive his benefit, the employer may still be compensating for these losses. If the employee takes his retirement benefit as a lump sum, the employer may contribute for the employee for as long as fifteen years after the employee has taken his money from the plan.

Experience losses are a normal feature of any actuarial method, including unit credit funding. Because actuarial assumptions are simply reasonable estimates of future events, no one expects them to be satisfied precisely.[181] Indeed, it is rare when they are. Therefore, employers commonly contribute for employees after employees have begun to receive their benefits.

Present law obviates these fairness and measurement concerns because it is distribution, not contribution, that triggers taxation under existing law. This is a reasonable response to the fact that distributions to an employee may precede the employer's contributions for him.

6. Summary

Taxing contributions under unit credit funding is a more competitive alternative to the status quo than taxing accrued benefits. Contribution taxation eliminates the need for detailed policing of actuarial valuations. A statute codi-

179. G. GILBERT, G. LACHOWICZ & J. ZID, *supra* note 24, at 9-1; D. MCGILL, *supra* note 22, at 267; D. MCGINN, *supra* note 24, at 60-61.

180. I.R.C. § 412(b)(2)(B)(iv) (1982).

181. *See* Treas. Reg. § 1.401-2(b)(1) (as amended in 1981).

fying contribution taxation would therefore be simpler than one taxing accrued benefits. Administration by the IRS would also be simpler under a regime of contribution taxation. However, given unit credit funding, taxing contributions has problems and requires trade-offs that may make current law plausibly preferable. The possibility that contributions may be made for a participant after he has received his benefit undercuts the claim that taxing contributions would accurately and fairly reflect the value to employees of their participation in defined benefit plans.

C. *Level Funding Method*

1. Generally

Under the unit credit method, the employer contributes an amount necessary to pay for the benefits accrued during the current year.[182] From one perspective, this approach underfunds, because the employer and employee expect a greater eventual pension than revealed by the accrued benefit premised on the current year's compensation. Only as the employee ages and his salary approaches its final level will accrued benefits reflect the larger pension the employee will actually receive; only then, under the unit credit method, will the employer contribute funds for this higher benefit. Moreover, because the employee is closer to retirement when his salary and pension approach their ultimate levels, there is less time for investment growth. Employer contributions must be increased accordingly. Hence, under unit credit funding, the employer's obligations are backloaded—relatively small in the employee's early, low-paid years but larger later.[183]

Actuaries have developed the level funding method for those employers who seek to equalize their funding obligations over the course of the employee's career. This approach ignores the employee's accrued benefit based on present salary. Instead, it projects his eventual pension at retirement and funds for that larger benefit, even though the employee has no right to it now. During the employee's initial, low-compensation years, the employer prefunds the pension obligation, which will not arise legally until later.[184]

Consider again an employee who accrues a $303 benefit during the current year. This benefit reflects 1/33 of the $10,000 annual pension the employee would receive based on his present salary of $20,000. However, the employer, the employee, and the plan's actuary all expect that, as a result of inflation, seniority, and enhanced productivity, the employee will retire with compensation higher than $20,000 annually. Suppose the actuary estimates the employee will retire with a final salary of $50,000 per year and, therefore, an eventual annual pension of $25,000. Under the level funding method, the employer will prefund in equal installments the $25,000 pension the employee is expected to receive. Compared

182. *See supra* text accompanying note 172.

183. D. McGill, *supra* note 22, at 271-72.

184. G. Gilbert, G. Lachowicz & J. Zid, *supra* note 24, at 8-5; D. McGill, *supra* note 22, at 286; D. McGinn, *supra* note 24, at 33, 37.

to the unit credit method, this approach generates higher contributions in initial years and lower contributions later, because the employer has prefunded the employee's eventual benefit.

Taxing contributions under level funding raises many of the same issues as taxing contributions under the unit credit method. Given level funding, there would be no significant administrative problems for the IRS if the federal government taxed contributions. The employee would simply report the amount contributed for him by his employer plus earnings on prior contributions. The actuarial processes used to determine that contribution would be of no concern to the tax collector.[185] Similarly, year-to-year valuation fluctuations would be relatively easy for taxpayers to accept under level funding. The employer would annually report to the employee the value of the resources funding the employee's benefit. The employee would then declare as income or loss the rise or decline from the prior year.

Level funding also raises the possibility of past service liabilities and experience losses. Some employees would receive their benefits before the employer has fully contributed for them; other employees would be taxed on contributions they would never receive. A statute taxing contributions under level funding, therefore, would need to provide ex post relief for contributions taxed but not received. Taxing contributions under level funding would also raise liquidity-related concerns of acceptability, because rank-and-file taxpayers tend to equate income with cash in hand. Finally, if the federal government taxed contributions, liquidity considerations would be somewhat more important for employees whose benefits are funded on a level basis, because such employees would recognize more income earlier in their careers.

2. The Dilemma of Taxing Level Funding Contributions

Level funding creates a dilemma for those seeking to tax employees on employer contributions. The essence of level funding is the contribution of amounts necessary to finance long-term actuarial projections based on employees' anticipated final salaries.[186] One may reasonably conclude that such sums reflect implicit pension expectations, or at least the actuary's estimate of those long-term expectations. However, the problem of taxing employees on amounts they will not receive is exacerbated because the employer is prefunding anticipated pensions. Therefore, the problem of contributions taxed but not received extends beyond situations involving death, malfeasance, and poor investment performance to include all cases in which the employee leaves after relatively few years of service.

Consider again the hypothetical vested participant who accrues a benefit of $303 in his first year of employment. Under level funding, the employer will finance a benefit of $758 in that year, reflecting the expectation that the em-

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185. Again, as under current law, the IRS would be concerned with the reasonableness of actuarial assumptions as they affect the deductibility of employer contributions. *See* I.R.C. § 404 (West Supp. 1987).

186. *See supra* text accompanying note 184.

ployee will remain with the employer until retirement and experience salary increases culminating in compensation of $50,000 per year.[187] Suppose, however, the employee leaves after one year and takes with him the right to a pension of $303 annually at retirement. Under a system taxing contributions, the employee will have paid tax on the funds for a benefit of $758, $455 of which he will not receive.

Thus, the dilemma of taxing employer contributions: if contributions are based on the employee's legally accrued benefit, the long-term economics of pension participation are not reflected by the tax system because such contributions are based on current, not expected, compensation. If the tax system approximates the economics of plan participation via level funding, the employee will more likely be taxed on contributions which will never be distributed to him since, under that method, contributions in the employee's early years substantially exceed current pension entitlements. Present law escapes this dilemma by deferring tax until actual distribution to the employee, when there is no longer a discrepancy between benefits accrued and benefits expected.

D. *Aggregate Funding Method*

Both level and unit credit funding are properly described as individual methods, as both lead to the calculation of a contribution for each particular participant. The employer's total obligation under either approach is the sum of these individually determined amounts.

In contrast, the aggregate funding method generates a total obligation for the employer without apportioning among specific individuals.[188] Under this approach, the initial step is to project each participant's eventual benefit at retirement. The second step discounts each participant's projected retirement benefit to its actuarial present value. Third, such present values are added together. Fourth, funds available from previous contributions and the earnings of those contributions are subtracted from the aggregate of present values. This step yields the present value of unfunded projected benefits. Fifth, the actuary determines for each participant the present value of an annuity of one dollar per year, starting at the present time and continuing until his retirement. The sixth step is the summing of these annuity present values for all participants. Finally, the aggregate of unfunded projected benefits is divided by the aggregate of annuity present values, resulting in the employer's contribution for the year.[189]

At no point in this process does aggregate funding generate a particular contribution for a specific individual. Thus, to tax employees on employer contributions the Code would have to specify some means of allocating the employer's aggregate contribution among the participants. One possibility is to calculate separately the contributions that would have been made by the em-

187. The $758 represents $\frac{1}{33}$ of the projected eventual pension of $25,000.

188. G. GILBERT, G. LACHOWICZ & J. ZID, *supra* note 24, at 8-12; D. MCGILL, *supra* note 22, at 316-17.

189. G. GILBERT, G. LACHOWICZ & J. ZID, *supra* note 24, at 8-12; D. MCGILL, *supra* note 22, at 318-19.

ployer under an individual funding method and to tax employees on these hypothetical amounts.[190] Taxing these theoretical contributions would present the same problems as taxing contributions actually made under unit credit or level funding, with an additional complication. There is no reason for the employer's total obligation under the aggregate method to equal its hypothetical contribution under unit credit or level funding. Hence, employees would invariably be taxed on total amounts different from the employer's actual contribution. As a matter of fairness, it would be troubling to tax employees collectively on more money than is actually contributed for them. Taxing employees on less than is actually contributed for them also seems inequitable vis-à-vis others who, under individual methods, would report the full amounts conveyed to qualified plans on their behalf.

An alternative is to decompose the employer's aggregate contribution, dividing each employee's discounted projected benefit by the actuarial present value of a one dollar annuity for the employee, given his current age and the number of years until his retirement. Taxing the employee on the resulting number is similar to taxing him on a level funding basis—that number reflects, not the participant's legally accrued benefit, but a calculation premised on his projected eventual pension. The implications of this approach are the same as under level funding. Most critically, some employees would be taxed on amounts they may never receive.

E. *Summary*

Taxing contributions to employees is not without problems and dilemmas. Those designing a normative income tax might reasonably prefer the limitations and quandaries of current law to the alternative problems attending the taxation of contributions.

VII. TAXING QUALIFIED PLAN EARNINGS

A. *Overview*

Although taxing plan earnings at employees' respective brackets bears a superficial resemblance to the withholding of taxes by plans for employees, the rationale and mechanics of taxing plan earnings would be fundamentally different from such withholding. Withholding by qualified plans would be a response to taxpayers' liquidity problems. The legal obligation to pay tax would be the participant's. He would report as income the value of his accrued benefits or employer contributions, depending on which method of taxation Congress selected. Amounts withheld by the plan would be credited against the employee's

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190. Some employers who use the aggregate method are already mandated, under Statement of Financial Accounting Standards No. 87 ("FASB 87"), to calculate separately their pension obligations under the unit credit method. Nevertheless, for employers who use aggregate funding but are not required to comply with FASB 87, contribution taxation would increase administrative burdens by requiring a second actuarial valuation. *See* Parker, *No Need to Fear FASB 87*, PENSIONS & INVESTMENT AGE, Nov. 10, 1986, at 30, 30.

personal liability. The participant would be entitled to a refund of any excess withholding or would be required to pay additional tax from his own resources.

In contrast, under a scheme taxing plan earnings, the employee would not include in income employer contributions or accrued benefits. The employee would only be taxed, as under present law, at the time of actual distribution. Thus, plan earnings would not be reported on participants' individual returns, nor would employees bear any personal responsibility for taxes generated by these earnings. Rather, the plan itself would pay tax at each participant's bracket. Upon subsequent distribution, each employee would include in income his entire distribution, including the previously taxed earnings.

B. *Incidence, Fairness, Administrability, and Acceptability*

Taxing plan earnings shares one important characteristic with withholding by plans: the ultimate economic incidence of such taxation is unclear and possibly unfair. Defined benefit plans that are left with lower after-tax resources would probably reduce benefits, a reduction not necessarily corresponding with the nominal burden of the tax on plan earnings.

Consider a defined benefit plan with two participants. One participant is in the fifteen percent income tax bracket; the other pays at the twenty-eight percent rate. Earnings of this plan would be taxed partly at the lower rate and partly at the higher rate. If the plan responds to its new tax burden by reducing benefits, benefits might be reduced more for the lower paid participant than for his higher paid colleague. Suppose the higher paid employee has rare skills, resulting in increased bargaining power with the employer. This advantage enables him to shift part of the tax attributable to him to his lower paid coworker. This result would be viewed by most as inequitable. Under this scenario, the taxation of plan earnings would not, as intended, leave the two employees indifferent to the choice between current and deferred compensation. The lower paid participant would resist the pension if he bore part of the tax attributable to his more affluent colleague, who would for the same reason prefer the pension to current salary.

However, assume that taxes on defined benefit plan earnings will in fact be borne by the participant against whom they are nominally levied. Hence, each employee's benefit would be reduced in precise response to the tax attributable to him. It would therefore be necessary for the plan to calculate its tax liability exactly with respect to each employee. Under a withholding system, such precision is not necessary. If there were too little or too much withholding for an employee, he would claim a refund or pay additional tax on his own return, because withholding is merely a preliminary stage in the determination of the taxpayer's ultimate personal liability. Such subsequent adjustments are impossible when the calculation and payment of tax by the plan is the final step.

The resulting administrative burden on defined benefit plans would be significant, as would the intrusion into taxpayers' privacy. Each employee would disclose to the plan his taxable income so that the tax on plan earnings could be calculated for him. Over the course of each employee's career, the plan's actua-

ries would keep track of these taxes to make appropriate reductions to each employee's benefit. Plans utilizing the aggregate funding method would decompose aggregate data to attribute earnings to specific participants. From the perspectives of taxpayer acceptability and administrability, one could reasonably prefer current law, which requires neither the disclosure to plans of participants' private financial data nor the administrative work of accumulating and responding to such information.

C. *A Flat Tax on Plan Earnings*

In light of the 1986 Act, another approach for taxing plan earnings suggests itself: a flat tax on all plan earnings at the fifteen percent bracket, the marginal rate for a majority of federal taxpayers.[191] This approach would eliminate the most problematic aspect of taxing plan earnings. Employees would not disclose personal financial data to the plan because taxes would be assessed at a single rate for all participants.

There are three grounds on which current law is preferable to such a flat tax on plan earnings. First, the economic incidence of such a tax is unclear and possibly inequitable. Rank-and-file participants would be overtaxed to the extent employees in the twenty-eight and de facto thirty-three percent brackets[192] would cause a disproportionate reduction in benefits for their lower paid colleagues, thus forcing them to absorb too much of the tax. Second, assuming a fifteen percent tax falls as intended upon all employees, it would be too low for employees in higher tax brackets and too high for employees with insufficient incomes for federal taxation. As to the former, there would still be an advantage to deferral via qualified plans because the fifteen percent tax would be less than the rate that would be paid by them on the earnings of current compensation. As to the latter, there would be a disadvantage to plan participation over current compensation because such compensation and its earnings are tax-free. In both settings, equity will have been sacrificed for administrability.[193]

Finally, the appeal of a fifteen percent tax on plan earnings reflects the simplified rate schedule of the 1986 Act, under which fifteen percent is the appropriate bracket for a majority of taxpayers. Political climates change. If a future Congress introduces a schedule with more gradations, making the fifteen percent rate inappropriate for more taxpayers, a new solution regarding taxation of plan earnings would become necessary. On balance, one could reasonably prefer the

191. *See* I.R.C. § 1 (West Supp. 1987).

192. *Id.*

193. Professor Halperin suggests that a flat tax on plan earnings be levied at the highest rate in the Code for nonqualified deferred compensation. *See* Halperin, *supra* note 81, at 549. Nonqualified deferred compensation is largely limited to the most affluent of taxpayers, so that approach seems sensible in that context. However, qualified plans cover broad segments of the workforce, for whom the relevant brackets under the 1986 Act are the 15% and 0% rates. Indeed, the Congressional Budget Office (CBO) would limit any such tax to a rate of 5%. Any higher tax, the CBO concludes, would have a disproportionate impact on lower-paid employees. CONGRESSIONAL BUDGET OFFICE, TAX POLICY FOR PENSION AND OTHER RETIREMENT SAVING 114-15 (1987). Indeed, the CBO calculates that under the 1986 Act, 11% of all pension participants will not owe any federal income tax. *Id.* at 6.

status quo to the problems and quandaries of a tax on plan earnings in either a flat mode or as more precisely tailored to employees' respective tax brackets.

VIII. Delaying Employer Deductions

Although it has not received attention from those critical of the present tax treatment of qualified plans, there is yet another alternative to the status quo. Employers' deductions could be delayed until employees receive distributions and pay tax on them.[194] Such a scheme could be implemented with relative administrative ease as to defined benefit plans using individual funding methods. Employers maintaining such plans would be required to compute the cumulative contributions made for each employee. Were an employee to receive a lump sum distribution, the employer would then deduct the aggregate of its contributions for that employee. If the employee were to receive his benefit as an annuity or on an installment basis, the employer's cumulative contributions would be allocated pro rata among the periodic distributions received by the employee. Each time the employee receives a payment from the plan, the employer would take a corresponding deduction until the employer would have deducted the total of the contributions made for the employee.

However, as to plans using the aggregate funding method, matters would be more complicated administratively. The employer would keep a second set of records, superimposing an individual funding method on the aggregate approach actually used to fund the plan. When an employee receives a distribution from the plan, the employer would then deduct on the basis of the contributions that would have been made for the employee under the individual method. As discussed previously, the total of these theoretical contributions may be less or more than the amounts actually contributed by the employer under the aggregate approach.

Moreover, under certain funding methods, some employees receive their distributions before the employer actually contributes for them.[195] In these situations, affording the employer a deduction upon distribution to the employee would result in a deduction earlier than provided under current law, not exactly the result anticipated by most reformers.

For all defined benefit plans, delaying deductibility until the time of distribution raises considerations of employer liquidity, equity, and acceptability. An employer contributing substantial sums to a qualified plan on a nondeductible basis could experience serious problems paying its federal income tax. Consider, for example, an employer with a workforce of twenty-five year old employees and a generous qualified plan utilizing sixty-five as the normal retirement age. Under a scheme deferring deductibility until the time of employee taxability, the employer would owe substantial federal income tax on its current, nondeductible contributions to the plan. The employer could incur a significant tax liability

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194. This is currently the case with nonqualified deferred compensation arrangements. *See* I.R.C. §§ 83, 402(b), 404(a)(5) (West Supp. 1987).

195. *See supra* text accompanying notes 176-81.

stemming from these nondeductible contributions and have no cash to pay taxes. Indeed, in this case, the employer might not receive a deduction for its plan contributions for forty years, until its now-youthful workforce begins to retire.

The employer might respond to its liquidity problem by making the plan less generous, thereby reducing the amount of its nondeductible contribution. However, the terms of the plan may be beyond the employer's legal or practical control. The plan might be the result of a collective bargaining agreement, which would constrain the employer's ability to alter the plan's terms. Alternatively, the level of benefits provided by the employer might be dictated by a competitive market for workers.

Delaying deductions for qualified plan contributions also raises serious issues of equity and related concerns about acceptability. An employer's contributions to a qualified plan diminish the employer's net worth and taxpaying capacity as surely as a variety of other outlays for which immediate deductions are permitted. Assume two otherwise comparable employers, each with the same gross income and expenditures except that one pays all compensation on a current basis while the other divides the same amount between current salary and qualified plan contributions. Under these circumstances, it is arguably inequitable to assess different tax liabilities against two employers who have the same net resources under their control. However, that would be the result under a scheme delaying employer deductions until the time of employee receipt.

It seems particularly unfair to deny a deduction to an employer who is bound by a collective bargaining agreement to contribute to a qualified pension plan. And the perception of inequity, we are frequently told, affects taxpayers' views of the acceptability of a tax provision. In short, a Congress concerned about employers' liquidity, equal treatment of economically similar outlays, and the acceptability of the tax law could plausibly prefer, as a normative tax provision, an immediate deduction for qualified plan contributions.

IX. Defined Contribution Plans

A. *Overview*

The discussion so far has examined the relative merits of current law and the reform proposals vis-à-vis the defined benefit plan. This section of the Article examines these alternatives in the context of defined contribution plans. Although these proposals are more attractive for defined contribution arrangements than for defined benefit plans, significant problems inherent in the reform proposals make the status quo a plausibly preferable approach towards a normative income tax.

B. *The Current Taxation of Accrued Benefits*

In the defined contribution setting, no divergence exists between benefits accrued and benefits expected. Moreover, it is substantially simpler to measure the accrued benefit of a defined contribution participant than that of a defined benefit participant. However, accurate measurement of accrued benefits for par-

ticipants in different defined contribution plans would require actuarial valuations of their respective death and disability coverages. Moreover, taxing defined contribution accrued benefits would entail the taxation to some participants of amounts they would never receive, and would therefore involve the same liquidity and acceptability issues encountered under taxation of accrued benefits in the defined benefit context.

In the defined contribution setting, there is no discrepancy between legally accrued and economically expected benefits: subsequent salary increments do not retroactively increase the value of prior years' pension participation. Consider again an employee, who, in his first year of employment, receives current compensation of $20,000 annually, expects to earn $50,000 yearly at retirement, and participates in a defined benefit plan promising annual payments of fifty percent of final salary. Legally, the participant accrued during this initial year $303, 1/33 of an annual pension of $10,000 based on his current salary. However, the employer and the employee expect that the employee retrospectively will have earned 1/33 of a pension of $25,000, one-half of his eventual salary. In effect, subsequent salary increases will make the initial year of participation more valuable than it was at the time it occurred, and subsequent salary increases are anticipated by both parties *ab initio*. Hence, the dilemma of taxing accrued benefits: the present discounted value of $303 undervalues the long-term pension expectations of both the employer and employee.

However, in the defined contribution setting, there is no retroactive adjustment for the first year's pension participation because of a subsequently higher salary. Once an employer contributes for a particular year, that year is never again of consequence in the determination of pension liabilities.[196] Suppose the employer maintains a defined contribution arrangement instead of a defined benefit plan and contributes annually ten percent of the employee's current salary. In the first year, the employer contributes $2,000 for our hypothetical employee. By definition, $2,000 is the present value of both the addition to the employee's accrued benefit and the economic expectation of the employer and employee for that year. Whatever the $2,000 grows to at retirement is what the employee will receive. Subsequent changes in compensation do not retroactively alter the value of the employee's first year's pension participation, but only increase the employer's contribution in subsequent years. Thus, even if the employee's salary does later increase to $50,000 annually, the value of the initial year of pension participation remains $2,000, plus or minus earnings. Consequently, the government could tax the employee on the $2,000 when it is added to his account, confident that the figure measures the long-term economic value to him of his initial year of defined contribution pension participation.

Moreover, because the defined contribution accrued benefit is the present market value of the employee's individual account in the plan,[197] we could easily measure changes in an employee's accrued benefit by comparing his account at

196. *See* G. GILBERT, G. LACHOWICZ & J. ZID, *supra* note 24, at 1-6; D. MCGILL, *supra* note 22, at 109.
197. I.R.C. § 411(a)(7)(A)(ii) (West Supp. 1987).

the beginning of the year with its value at year end. That gain or loss, including employer contributions, could be recognized by the employee as income. The simplicity of this process is a second major reason taxing accrued benefits is more feasible in the defined contribution context than in the defined benefit setting.

On the negative side, accurate comparison among participants in different defined contribution plans would require actuarial valuations of the disability and death provisions of their respective plans. Suppose two unmarried, unvested employees, the same age, have equal amounts in their defined contribution accounts in different plans. One plan provides for immediate vesting and distribution on death and disability, while the other does not. The employee with death and disability coverage has something of economic value his counterpart does not have even though their respective account balances are technically the same. Although it is tempting simply to treat their account balances as reflecting their relative economic positions, a more accurate comparison would require some imputation of income for disability and death coverage. We thus confront a choice between an administratively simple approach that merely uses account balances and a more accurate one that utilizes actuarial valuations.

There is the further possibility an employee (even if vested) will not actually receive all of his defined contribution account for various reasons: it may be stolen; the account may be distributed as an annuity and the employee may die relatively early; the employee may die before retirement and the plan need not provide a death benefit; or the plan may provide death payments less than the employee's total accrued benefit. These possibilities, along with the failure of the PBGC to insure defined contribution plans,[198] create the potential for taxing employees on accrued benefits they may not receive and the concomitant need to provide in the Code some type of ex post adjustment for such cases. Finally, taxing accrued benefits in the defined contribution setting raises the same liquidity and acceptability issues as in the defined benefit context.[199]

C. *The Current Taxation of Employer Contributions*

Taxing employer contributions has little appeal vis-à-vis defined contribution plans. Annual changes in participants' account balances reflect current employer contributions as well as the amounts earned by previous contributions. Changes in such balances are consequently the superior measure of participants' income.

Suppose that an employer contributes $10,000 for a participant to a defined contribution plan and that, in the same year, the investments reflecting prior contributions decline in value by $15,000. From a Haig-Simons perspective, the participant's net worth has decreased by $5,000. If, however, the participant is merely taxed on this year's contribution, he would report income of $10,000, an anomalous result. With defined benefit plans, the principal reason for taxing

198. 29 U.S.C. § 1321(b)(1) (Supp. III 1985).

199. *See supra* text accompanying notes 158-64.

contributions rather than accrued benefits would be the difficulty of valuing such accrued benefits and the resulting need to use employer contributions as a substitute.[200] Given the relative ease with which account balances can be measured, there is no compelling need in the defined contribution context to use contributions as a surrogate.

D. *The Current Taxation of Plan Earnings and the Denial of Employer Deductions*

Taxing plan earnings in the defined contribution setting raises the same issues examined in the defined benefit context: ultimate economic incidence, the acceptability problems of participants' providing personal financial data to plans, and the unfairness of taxing all employees' accounts at a flat rate.[201] The proposal to deny employer deductions until the time employees receive distributions raises, in the defined contribution context, the same issues of liquidity, equity, and acceptability as in the defined benefit setting.[202]

E. *Summary*

Reform of the status quo, in particular taxing employees on their accrued benefits, is more attractive for defined contribution plans than for defined benefit plans. This is true because there is no divergence between benefits accrued and benefits expected in the defined contribution context, and because defined contribution accounts are a convenient, if somewhat crude, measure of employees' relative economic values from defined contribution plans. In theory, it is possible to retain present law for defined benefit plans but institute accrued benefit taxation for defined contribution arrangements. In practice, however, such discrepant treatment would be unfair and self-defeating—unfair because the tax consequences of qualified plan participation should not depend on an employer's decision to use one type of arrangement rather than another, and self-defeating because employers could grant more favorable tax treatment to their employees by shifting from defined contribution to defined benefit plans.

X. A Note on Nonqualified Deferred Compensation

It is interesting to contrast the current treatment of qualified plans with the present law on nonqualified deferred compensation. Such compensation is taxed to the employee when funded and vested, whether or not vesting occurs prior to actual distribution.[203] Employers who promise nonqualified deferred compensation receive no deduction for prefunding; employers can deduct only when employees are taxed.[204] If employers prefund nonqualified deferred compensation through trusts or similar arrangements, income earned by the amounts contrib-

200. *See supra* text accompanying notes 74-80.
201. *See supra* text accompanying notes 190-93.
202. *See supra* text accompanying notes 194-95.
203. I.R.C. §§ 83, 402(b) (West Supp. 1987).
204. *Id.* § 404(a)(5).

uted is taxable. In short, the current treatment of nonqualified deferred compensation corresponds closely to the model advanced by many tax reformers for qualified plans.

This approach to nonqualified deferred compensation works as a normative tax provision for a number of reasons. Nonqualified deferred compensation is essentially a device for the affluent, executives, athletes, and entertainers who typically have other liquid resources with which to pay the tax attributable to items taxed but not received.[205] Many of these are economically sophisticated persons who can understand and accept (even if they do not like) being taxed on vested compensation they have earned but not yet received. The current scheme for taxing nonqualified compensation does not inequitably damage low-income workers few, if any, of whom receive such compensation.

Nonqualified deferred compensation arrangements are usually not funded until the employee receives his payment. When funded, such arrangements are typically like defined contribution plans and do not entail actuarial calculations.[206] Hence, taxing nonqualified compensation when funded and vested is not as complex a task as treating defined benefit accruals in this manner, nor does it involve any significant issues of measurability. Nonqualified deferred compensation arrangements usually involve comparatively small amounts relative to the employer's total wage bill. Postponing deductibility thus does not entail serious liquidity problems for such employers.

Were qualified plans similarly the province of a relatively liquid, sophisticated constituency, were there no defined benefit plans with the attendant problems of measurability and administrability, were qualified plans not invariably prefunded, and were not a significant number of qualified plan participants persons of low and moderate incomes, the present scheme for taxing nonqualified deferred compensation might easily be imposed on qualified plans. Given these differences, however, it is a plausible choice to treat qualified plans as part of a normative tax along the lines of the status quo while taxing nonqualified compensation differently.

XI. Conclusion

The status quo vis-à-vis qualified plans can reasonably be preferred as a normative tax provision when compared with the alternatives. The current law of qualified plans is similar both to other provisions of the Code with which many tax reformers have made their peace and to other reform proposals outside the qualified plan context. Concerns about liquidity, valuation, administrability, and acceptability have led many reform-oriented commentators to accept section 453 and embrace proposals for constructive realization. These same consid-

205. *See* Graetz, *supra* note 87, at 906-07.

206. Indeed, § 404(a)(5) virtually guarantees that nonqualified deferred compensation arrangements will be of a defined contribution nature. The employer can never deduct contributions to a nonqualified defined benefit plan unless the plan is restricted to a single participant. I.R.C. § 404(a)(5) (West Supp. 1987).

erations support retention of current law, as a normative matter, with respect to qualified plans.

Constructive realization is itself a compromise, a modification of the ideal of annual taxation of unrealized appreciation. Confronted with problems of administrability, measurability, liquidity, and the like, reform advocates have generally agreed to postpone the taxation of appreciation until a more convenient time. That, I suggest, is precisely the judgment embodied in the current treatment of qualified plans.

In distributional terms, present law with respect to qualified plans is actually superior to constructive realization. Property-based income is heavily concentrated among the relatively small number of well-off taxpayers. Constructive realization thus represents a compromise that would principally benefit affluent property owners by deferring their theoretical tax liability until death or gift.[207] In contrast, the qualified plan provisions are available in significant measure to rank-and-file employees. If the current treatment of qualified plans represents a departure from an ideal system of taxation, it is a departure widely available to less affluent taxpayers.

One can accept that the current tax treatment of qualified plans falls short of the ideal without concluding the alternatives are necessarily superior. That is precisely my conclusion vis-à-vis present law as a normative tax provision. It is an unexciting defense of the status quo to declare the alternatives no better and perhaps worse. It is nevertheless a valid defense which suggests that current law can be viewed as an acceptable part of a normative income tax and that, in the search for future revenues, Congress should be reluctant to look to the Code provisions pertaining to qualified plans.

207. To address this problem, some commentators have advocated the addition of a deferral charge to the tax due. *See, e.g.*, Wetzler, *supra* note 72, at 120.