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Cross-Testing, Nondiscrimination, and New Comparability: A Rejoinder to Mr. Orszag and Professor Stein

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Cross-Testing, Nondiscrimination, and New Comparability: A Rejoinder to Mr. Orszag and Professor Stein

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In their response[1] to my article[2] in this symposium issue of the *Buffalo Law Review*, Peter Orszag and Norman Stein advance their analysis of cross-testing, new comparability and the nondiscrimination norm. I write this brief rejoinder both to clarify the areas of our disagreement and to complete our dialogue.

As a matter of arithmetic, Mr. Orszag, Professor Stein and I all agree on the effects of interest compounding when qualified plan participants are of different ages: contributions deemed discriminatory when measured as contributions may become nondiscriminatory when converted into projected benefits and tested as such.[3] Moreover, Mr. Orszag and Professor Stein mount no attack upon my statutory analysis of the proposed cross-testing regulations, i.e., that there is no textual basis for the regulations' double testing mandate under which both benefits and contributions must qualify as nondiscriminatory in the new comparability context.[4]

From these premises, I come to a benign perspective on new comparability plans since such plans achieve allocations of pension resources which emulate the

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1. Peter Orszag & Norman Stein, *Cross-Tested Defined Contribution Plans: A Response to Professor Zelinsky*, 49 BUFF. L. REV. 629 (2001).

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

3. Orszag & Stein, *supra* note 1, at 629-30, 642-43; Zelinsky, *supra* note 2, at 581-83.

4. Zelinsky, *supra*, note 2, at 608, 610.

allocations attainable via defined benefit arrangements.[5] I also conclude that there is no statutory footing for the proposed cross-testing regulations insofar as those regulations transform the disjunctive mandate of the statute (qualified plans may not discriminate as to "contributions or benefits")[6] into a statutorily unauthorized requirement that new comparability arrangements pass muster both in terms of projected benefits and current contributions.[7] More generally, I judge the non-discrimination norm incoherent since a given allocation of pension resources may be classified as discriminatory even though a substantively identical allocation, achieved through a different form of qualified plan, may be deemed nondiscriminatory.[8]

The Orszag-Stein critique of these conclusions rests on three assertions. First, Mr. Orszag and Professor Stein generally oppose the defined benefit plans maintained by small employers.[9] This opposition logically extends to cross-tested new comparability plans: if small employer defined benefit arrangements are *verboten*, the new comparability devices which replicate outcomes achieved through such arrangements properly go as well.

Mr. Orszag and Professor Stein's opposition to small employer defined benefit pensions reflects a second facet of our disagreement. They believe that current qualified plan law constitutes a tax expenditure;[10] I do not. The premise

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5. *See id.* at 595-97.

6. I.R.C. § 401(a)(4) (1994).

7. Zelinsky, *supra* note 2, at 608, 610.

8. *Id.* at 616-25.

9. Orszag & Stein, *supra* note 1, at 632 ("[D]efined benefit plans, which historically have been tested on a benefits rather than contribution basis, [should] be limited to situations in which the firm is not using the plan principally to direct benefits to older highly compensated employees.") (citation omitted); *id.* at 653 ("In particular, small defined benefit plans are often designed to provide benefits primarily for proprietary employees and risk-shifting effectively does not occur. The regulatory costs associated with defined benefit plans are thus largely wasted, and the inequitable resource allocation (similar to that in a cross-tested defined contribution plan) is unjustified.") (parentheses in original).

10. *Id.* at 648 ("Given the structure of the current U.S. tax code, it appears difficult to argue that qualified pension plans do not result in tax expenditures."); *id.* at 649 ("Since the tax preferences accorded to qualified pension plans cause foregone revenue that could have been used for other public purposes, regulation to ensure that the tax expenditure is meeting some policy objective is justifiable."); *id.* at 670 ("We are among those people who subscribe

that current law is a tax subsidy underpins the Orszag-Stein indictment of small employer defined benefit plans and of the cross-tested defined contribution plans which mimic them. Per that indictment, these plans constitute a drain on the public fisc with no compensating gain in retirement security for rank-and-file employees. In contrast, since I perceive no tax expenditure in the Code's current treatment of qualified plans, I view the retirement plans of business owners and professionals, not as publicly-underwritten tax shelters, but as acceptable devices for retirement savings.

Finally, Mr. Orszag and Professor Stein dispute my assertion that the issue raised by new comparability plans is one of form rather than substance.[11] From my vantage, we should, via cross-testing, permit new comparability arrangements since we condone economically equivalent defined benefit plans and the form by which allocations of pension resources occur should not matter. In contrast, Mr. Orszag and Professor Stein maintain that, even if *arguendo* the small employer defined benefit pension persists, new comparability and the cross-testing on which it depends should not be allowed.

One of these issues—whether or not current law constitutes a tax expenditure—has been much debated[12] and need not detain us now. However, even if the conventional wisdom is correct and current law is characterized as a tax subsidy, it is a tax subsidy which the Code now channels into defined benefit plans, including those maintained by small employers. Consequently, as a legal matter, the statutory baseline condones the outcomes achievable by defined benefit methodologies. New comparability plans, through cross-testing, simply allocate

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to the opposite view, which Professor Zelinsky in an understatement labels conventional wisdom: that the tax regime for qualified plans varies from the normative features of an income tax and thus can be justified only as a tax expenditure.").

11. *Id.* at 651 ("Professor Zelinsky's 'substance should control over form' position incorrectly assumes that cross-tested defined contribution plans are equivalent to defined benefit plans with the same allocation of pension resources across the firm's workers in any particular year. The equivalency does not hold more broadly, however, undermining the assertion that the substance of the two plans is indeed the same."); *id.* at 657 ("We thus reject Professor Zelinsky's argument that the substance of cross-tested defined contribution plans is equivalent to that of defined benefit plans.").

12. *See* Zelinsky, *supra* note 2, at 595 nn.62-63.

resources in the same way as defined benefit plans, typically to the pronounced advantage of the older principals of the firm sponsoring the plan.

The Orszag-Stein critique is thus fundamentally a policy critique of current law and its authorization of the small employer defined benefit plan. This confirms my assertion that opposition to new comparability is, at its core, opposition to small plans generally.[13]

As a political matter, I understand why those who would outlaw small employer defined benefit plans are today forced to focus their opposition narrowly upon new comparability arrangements: Congress will not impose further burdens on defined benefit arrangements nor will it hinder age-weighted plans, aptly denoted by Mr. Orszag and Professor Stein as the "first generation"[14] of cross-tested devices. Hence, new comparability is the only politically feasible target today for those whose underlying agenda is the abolition of most small employer defined benefit plans.[15]

Whatever the political merits of a strategy targeting current opposition upon cross-tested new comparability plans, as a theoretical matter, such selective opposition is, by definition, selective and thereby vulnerable to the criticism that opposition to new comparability is intellectually unpersuasive, given the existence of defined benefit and age-weighted arrangements which achieve comparable distributions of pension resources. To deflect this criticism, Mr. Orszag and Professor Stein claim that defined benefit-style allocations, if they are to be permitted, should be limited to true defined benefit plans, a position I explore in my article and reject as unconvincing.[16] Nothing in the Orszag-Stein analysis requires reconsideration of that rejection.

Mr. Orszag and Professor Stein correctly note that defined benefit arrangements may play a particularly useful role in retirement planning since, by providing employer-guaranteed benefits, such arrangements shift risk to employers, rather than employees.[17] Such risk-shifting, they observe, is usually more formal than substantive in

13. *Id.* at 610-11.
14. Orszag & Stein, *supra* note 1, at 643-44.
15. Zelinsky, *supra* note 2, at 610-11.
16. *Id.* at 612-16.
17. Orszag & Stein, *supra* note 1, at 650-57.

the case of a small defined benefit plan given the identity of economic interest among the owner of the firm, the firm itself, and the plan which heavily benefits the owner in his role as employee. Since in substance little real risk-shifting occurs in the small plan context (the firm and the owner/employee sharing the same economic interests), Mr. Orszag and Professor Stein conclude that the tax expenditure for defined benefit plans in this case is a bad bargain since the public subsidy of this plan purchases no significant risk-shifting for rank-and-file employees.[18]

As an argument against small defined benefit plans, this brings us back to the disputed premise that current law constitutes a tax expenditure. However, this argument, even if valid, does not explain why, if small defined benefit plans are permitted under current law, the allocation of pension resources they achieve should not also be allowed via cross-tested defined contribution plans. There is *de facto* no significant risk-shifting with either the typical small employer defined benefit plan or an equivalent new comparability plan. If, under current law, the former is permitted, why not the latter?

The best explanation advanced by Mr. Orszag and Professor Stein for their focus on new comparability is tactical in nature; they would attack new comparability as a "first step" in a long-term campaign against cross-testing more generally and, ultimately, against most small defined benefit plans.[19] But such tactics, whatever their political

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18. In a related vein, Mr. Orszag and Professor Stein argue that other features of the pension law erode the asserted equivalence between defined benefit and new comparability plans. For example, they point out, the limitations of I.R.C. § 415 might, in some cases, impact differently upon the two types of plans. *See* Orszag & Stein, *supra* note 1, at 657-59. Or, to take another example, the Pension Benefit Guaranty Corporation (PBGC) insures the basic benefits provided by defined benefit plans while there is no such insurance coverage for defined contribution arrangements. *See id.* at 669.

I do not doubt that there can be differences between defined benefit and new comparability plans although the differences strike me as less important than they do Mr. Orszag and Professor Stein. For example, most small professional employers are not covered by the PBGC, negating as to such employers this difference between the defined benefit and the new comparability motifs. More seriously, the differences cited by Mr. Orszag and Professor Stein do not undermine the basic assertion that the allocations of pension resources achieved by new comparability plans are equivalent to the allocations achievable via defined benefit pensions.

19. Orszag & Stein, *supra* note 1, at 631 ("From our perspective, the regulations are a beneficial, albeit limited, first step on the road to eliminating

logic, are unpersuasive as a matter of horizontal equity. There is no compelling reason to condemn allocations of pension resources favoring older entrepreneurs and professionals when achieved via cross-tested new comparability devices as long as such allocations can be attained through conventional defined benefit formulas. Neither new comparability arrangements nor small employer defined benefit plans produce the social advantages (e.g., risk-shifting) which, for Mr. Orszag and Professor Stein, are the *raison d'être* of the putative tax expenditure for qualified plans. Why, then, ban one but not the other?

When Mr. Orszag and Professor Stein turn their attention to the nondiscrimination norm, we have a surprising degree of agreement. While that agreement is "with some reluctance,"[20] Mr. Orszag and Professor Stein acknowledge that current nondiscrimination law "lack[s] substance."[21] In light of that insubstantiality, I would abolish the nondiscrimination norm. If that is not feasible, my second choice is to replace the nondiscrimination norm with the kind of minimum distribution and contribution rules presently embodied in the top-heavy and 401(k) safe harbor provisions.[22]

My second choice is, with modifications,[23] Mr. Orszag and Professor Stein's first choice. That difference, I contend, reflects the most basic disagreement between Mr. Orszag and Professor Stein, on the one hand, and me, on the other: grounded in the tax expenditure perspective, they believe that qualified plans can and should be regulated to force

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most cross-testing."); *id.* at 665 ("We view the regulations as a significant first step in limiting the use of cross-testing for defined contribution plans."); *id.* at 674 ("The Treasury Department's proposed regulations limiting the use of cross-testing are a useful first step in curtailing the most egregious cases in which the basic intent of the nondiscrimination norm is violated.").

20. *Id.* at 671.

21. *Id.* at 669-70; *see also id.* at 670 ("[W]e doubt the efficacy of today's nondiscrimination rules to produce meaningful retirement savings for rank-and-file employees who participate in such plans."); *id.* at 671 ("[T]he current regime does not reflect a meaningful proportionality requirement for most small firms . . . .").

22. Zelinsky, *supra* note 2, at 626.

23. Mr. Orszag and Professor Stein would supplement the minimum contribution mandate with enhanced salary reduction requirements and with a strengthened version of the current regulatory requirement that plans be permanent. *See* Orszag & Stein, *supra* note 1, at 669-74.

additional retirement savings for rank-and-file employees.[24] Hence their insistence that, if the nondiscrimination norm goes, it be replaced by requirements for minimum contributions and benefits as well as their determination to ratchet further the regulation of small employer defined benefit plans and cross-tested defined contribution arrangements.

In contrast, I perceive that regulation in this area has become counterproductive and unsuccessful. It is difficult to identify the precise point at which the costs inflicted by the continually tightened regulation of qualified plans first started to outweigh the benefits of such additional regulation. There is, however, no doubt that we are today well past that point. The sad reality is that the qualified plan regime will not generate significant retirement income for much of the American workforce. Tinkering further with that regime is, on balance, likely to do more harm than good.

I do not purport to have an answer to the pressing problem of providing retirement income for lower-paid Americans. I suspect that there is no single answer to that problem but, rather, some necessary combination of changes to our culture, life-styles, work places and social security system. But I am quite confident that more regulation of the qualified plan system is not the answer to the challenge of retirement savings for low-income Americans.

24. *See id.* at 650 ("[M]ost analysts and policy-makers agree that qualified pension plans generate tax expenditures. As such, non-discrimination rules and other forms of regulation are warranted.").