THE IMPACT OF TAX LEGISLATION ON CORPORATE INCOME SECURITY PLANNING FOR RETIREES

Ruth Ylvisaker Winger

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The manifest purpose of this dissertation was the discovery of changing patterns of income distribution in the welfare state. This was possible because busy compensation executives in the private sector were interested in the question, and willing to contribute their time and expertise to the study. The latent, personal and more lasting purpose was to develop a dynamic sense of scholarship that could begin serving the social work profession.

When I was an undergraduate student, Thomas Rocco played a critical role in this process by illuminating for me the intimate relationship of philosophy to the applied sciences. As a graduate student, Anne Minahan's commitment to a cosmological view of social work developed my understanding of the interdependence of public policy, administrative practices, services to people and social problems. Discussions with Minahan about the tax expense system as a source of funding for social purposes turned what had been an interesting discovery during a social work field experience, into a professional challenge and a commitment of scholarly inquiry.

The transformation of the "advanced generalist practitioner" into that of "beginning scholar" was the challenging task of George Hoshino. His scholarship and wealth of knowledge, high academic standards and a never-flagging and keen interest in new knowledge, added inspiration to the demands of scholarship. This, combined with his respect for different ways of knowing, gave me confidence in his guidance and sense of inquiry, an eagerness to learn and the desire to emulate.

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CHAPTER I

INTRODUCTION

Income security in old age is a topic which, by its very nature, is of universal interest. The American welfare state has become synonymous with "Social Security" to most Americans. To working citizens this means a right to collect on the social insurance they have supported through payroll taxes as an employee. Most working Americans also know that if they hope to maintain a semblance of their pre-retirement standard of living, income from social insurance will need to be supplemented. The common means of supplementing retirement income is either through personal savings and investments, or through an employer-sponsored retirement income plan, and preferably through both.

This study explored the complexities of the relationship between acts of Congress and nine major Midwest corporations in the Minneapolis-St. Paul area, regarding employer-sponsored retirement plans. Compensation executives served as the informants/respondents in a multiple-embedded case study of corporate "qualified" plans for the income protection of their retirees. The study was designed to discover if and why corporate decision makers respond to the Congress' tax incentives or the disincentives that affect the design of corporate income security plans for retirees.

The Social Security Act

Income protection for the aged was established as a national goal with the passage of the Social Security Act in 1935. The Social Security Act is the centerpiece of the nation's income protection for the aged. The Social Security Act mandated universal social insurance for the employed. Social insurance offers financial support for retirees, the temporarily unemployed, the disabled, and survivors. Since its enactment, amendments have expanded public programs. Social Security now includes most employed people and covers other situations of financial need, such as the permanently and totally disabled, as well as in kind supports, medical and social servies to aged, disabled low-income groups, and families with children.

Supplemental Security Income, enacted in 1972 and effective in 1974, plays a major role in the nation's income protection scheme as a guaranteed income below which the income of the elderly, blind, and the disabled cannot fall. The elderly and the disabled then, who have inadequate insurance benefits or no benefits at all, are thus protected from abject poverty (Munnell, 1978).

Despite this expansion of provisions offered by the welfare state, private provisions play a fundamental role in the nation's plan for income protection in old age. But when employers respond neither to the Congress's tax incentives nor to the employees' need to maintain a pre-retirement standard of living, the responsibility for the maintenance of an adequate standard of living in retirement lies solely with the employee and the welfare state.

The financing of retirement plans for the growing population of older Americans has been called the most important issue of the decade facing the welfare state (Underwood, 1984). Until relatively recently, the man or woman who lived beyond forty was seen as a survivor, and the one who lived beyond fifty a rare exception. The survival of the majority of the population past their working years into old age has no historical precedent and is considered one of the most profound structural changes of the modern era (Drucker, 1976).

By 1975 "retirement" had become America's newest social institution. The nation's senior citizens had quadrupled in number since the passage of the Social Security Act. Meanwhile the privately controlled pension trust funds had become the nation's largest pools of wealth and generally had been accepted as an effective mechanism for guaranteeing retirement (Drucker, 1976; McGill, 1984).

The importance of socio-economic status to individual and family social adjustment has been well documented in the literature (Eitzen, 1985). The literature also documents that income for social insurance must be supplemented if a worker's standard of living is to be maintained in retirement.

Despite the dramatic growth of private pensions over the last two decades, the data on pensions in the United States show that almost half of all employees over age forty-five will have no income security benefits other than Social Security. In addition, these employees are disproportionately represented in the lower-income levels. This represents double jeopardy, since social insurance benefits are based on the history of work-related income (Andrews, 1985; Rein, 1977).

Clearly, the protection of income in retirement is a social issue that would benefit from the interest and research of the social policy professional as well as the occupational social worker. The wisdom of understanding the social policies developed in the private sector in concert with the nation's public social policies is supported by the brief review of "social purpose" acts of Congress that follows.

Legislative History of Employee Income Security Plans

A history of the acts of Congress that support the development of private pension plans shows an effect which first only enticed employers to participate. Later, legislation regulated the administration of those plans. Finally, between 1975 and 1985, Congress standardized the rules governing plan participation, the eligibility for benefits and the funding of employer-controlled pensions funds (see Appendix A for legislative history).

It took from 1921, when Congress first passed legislation to encourage pensions in the private sector, to 1974 and passage of the Employee Retirement Income Security Act (ERISA), to guarantee the employee's entitlement to the employer's promise of retirement benefits. With the passage of this precedent-shattering act, Congress declared that the retiree was entitled by law, under certain conditions, to the vested financial benefits of tax qualified retirement plans sponsored by the employer. ERISA thus entitled retirees to a lien on corporate assets if defined benefit plans were terminated by the sponsoring organization.

ERISA provided a precise definition of "qualified retirement income plans," that is, those plans eligible for preferential tax treatment or, in other words, social purpose dollars. According to P.L. 93-406 a "qualified plan" is

> . . . Any plan, fund, or program established or maintained by an employer or by an employee organization, or by both, that (a) provides retirement income to employees, or (b) results in a deferral of covered employment or beyond, regardless of the method of calculating the contributions made by the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.

There are important tax contingencies for both the sponsor and the beneficiary of a qualified retirement income plan which are spelled out in ERISA. A qualified plan entitles the employer to an immediate tax deduction on a future promise, and the employee to an income tax deferral until such time that the benefit is received as income.

As though to make up for lost time, by 1985 Congress had passed another five pieces of legislation to define six more employee entitlements to the qualified retirement benefits sponsored by the private sector. The next decade saw Congress systematically shape the retirement plans offered by employers to more closely reflect the egalitarian ideals of the welfare state.

The Revenue Act of 1978 set a precedent when Congress entitled the employee to tax-free savings through payroll deductions. The 1981

Economic Recovery Tax Act (ERTA) entitled employees to a corporate vote if they participated in an Employee Stock Option Plan (Pine and Wright, 1982). In addition, ERTA made tax-supported incentives to save money universally available through Individual Retirement Accounts (IRAs) (Ludwig and Curtis, 1981).

In 1982 the Tax Equity and Fiscal Responsibility Act (TEFRA) introduced the concept of adequacy to employer-sponsored income protection plans. TEFRA also mitigated the corporate financial advantage of integrating private benefits with Social Security benefits (Carter, 1983).

In 1984 Congress passed the Deficit Reducation Act (DEFRA) which disallowed the overfunding of "funded welfare trusts." DEFRA also imposed an excise tax on employers who maintain trusts expressly to provide benefits such as medical and life insurance for key employees. DEFRA also allowed vested employees to place a lien on corporate assets, if pension plans were terminated. DEFRA again lowered the level at which private pensions could be integrated with social insurance and established a maximum age at which the distribution of benefits must begin.

That same year Congress passed the Retirement Equity Act (REA) and statutorily recognized marriage as an economic partnership. This legislation successfully "breaches" the male "citadel" of the corporation by introducing the concept of androgeny to the workforce. With this legislation Congress infers that the concepts of mutuality of financial support and reciprocity of benefits are generic to the marriage partnership. Following REA an employee's spouse, of either sex, became entitled to survivor benefits and divorce settlements that attached an employee's qualified pension plan. In addition, women became entitled to special vesting schedules in recognition of their unique childbearing/career patterns (Koski and Schneider, 1985).

The corporations have not accepted the changes of this decade without complaint. However, there is a commitment among the corporate decision makers who participated in this study to the income security of their employees. The employers see qualified retirement plans as a cost-efficient means for rewarding employee service, especially the services of key employees. They also expressed civic pride in the image portrayed by the corporation as one that is concerned for, and protects, the economic welfare of its retirees.

The growth of employer-sponsored 401(k) savings plans is testimony to the power of tax incentives to shape corporate retirement income plans. Congress has also demonstrated the ability to shape the psychology of the nation's employees. Since the Revenue Act of 1978 which introduced the popular 401(k) savings plan and the passage of ERTA in 1981 and the liberalized participation in Individualized Retirement Accounts, there has been a dramatic growth in savings within the participating corporations (Spector, 1984; Sweeney, 1984).

Again demonstrating the power of the tax acts, the passage of DEFRA led corporate compensation managers to focus on adapting the 401(k) savings plans to serve their retirement income security plans. Corporate compensation managers see the 401(k) both as an attractive cost efficient savings mechanism and an employee benefit, and also as a popular perquisite for key employees.

The move to limit the untaxed assets of "welfare trusts" has led these corporate decision makers to question Congress' continued support of the pension trust funds. The pension trusts serve to finance the greatest share of the income retirement plans offered by these corporations. The corporate decision makers suggest that the choice between corporate support for the traditional defined benefit plans financed by the pension trusts, or defined contribution plans which are pay-as-you-go plans, will be based on which is doing better financially, the corporation or the pension trust fund. The former represents a corporate promise for the future, and the latter represents opportunity in the present.

Legislation during this decade appears to be undermining the loyalty of these executives to the highly regulated qualified defined benefit plans. The informants were showing an increased interest in the less regulated defined contribution and savings plans for retirement. The rationale for Congress' action is assumed to be twofold by this investigator. First, the nation's expressed need for capital formation. This need can be satisfied both by creating a psychology of saving and by breaking down the financial control of the pension trust funds to created a broader tax base. Second, Congress has become aware of the significant changes that have taken place in the demographics of the nation's workforce during the last two decades. These changes have created an incongruence between the traditional goals of qualified pension plans and the self-interest of the contemporary employee (U.S. Congress, House, Select Committee on Aging, Future of Retirement Programs, 1987).

1975 to 1985 can be called Congress' Decade of the Employee. The employee entitlements established by ERISA and subsequent legislation have significant implications for the income security of retirees of the modern corporation. Congress has established the statutory right of plan participants to vested benefits, to government subsidized personal savings accounts, and to employee ownership of business for participants in Employee Stock Option Plans (ESOPs). Further, Congress introduced a measure of need based on adequacy, rather than the traditional measure which includes status and merit, to the private sector. Not satisfied, Congress also established the statutory entitlement of the pre and post retiree to a lien on corporate assets. Following DEFRA, the first obligation of the failed corporation (even before federal taxes!) is to satisfy their pension plan obligations in accordance with federal regulations. DEFRA also applies to corporations that terminate their pension plans for any reason.

In this same decade it is significant that Congress recognnized marriage as an economic partnership and established by statute the entitlement of spouses and divorcess to corporate retirement and death benefits. Congress also now recognizes the unique differences in the employment patterns of women, while at the same time establishing equal treatment of the sexes in the distribution of retirement benefits.

In this "Decade of the Employee," Congress has changed the structure of "contingent welfare." Employee benefits are now no longer contingent only on the relationship of the employee to the employer. Now publically supported employer benefits for the protection of income in retirement are also contingent on the relationship of the employer to Congress. Further, the accountability of the employer for attention to the rights of benefit plan participants is subject to public oversight by the Internal Revenue Service (IRS). This effectively establishes a form of "quality compliance," a concept familiar to public service professionals.

These changes, however, come with a price tag for the employee. If defined contribution plans become the primary corporate vehicle for the protection of post-work income this will represent a change in the locus of responsibility. Defined contribution plans place the financial responsibility for the future with the employee. Conversely, the defined benefit plans place the responsibility for income protection with the employer. Plan participants need to be aware that a change to defined contribution plans places the financial risks with the employee, and the Congress offers no protections to the destitute retiree other than public programs. With defined benefit plans the financial risks of the unknowns in the future are born by the employer, plus the employee enjoys the added financial protection of the Pension Benefit Guarantee Corporation when the sponsor fails to meet the promised obligation.

An interesting compromise to the above dilemma, which tolerates some of Congress' pension plan disincentives, is represented by the Toro Corporation's design for the income security of their support staff. This "floor plan" is based on the company-wide defined contribution plan but, unlike conventional designs, this plan is backed up by a defined benefit plan. The pension plan comes into play if the employee's defined contribution benefits fail to meet a predetermined minimum based on pre-retirement income. In this way the risks of the future are shared by the employee and the employer. This model for the protection of employees in the lower earning bracket emulates the model developed by the walfare state. In the welfare model, federal Supplemental Security Income, a guaranteed minimum income for the aged, blind and disabled, comes into play as a status right for those elderly whose Social Security benefits fail to meet a predetermined minimum.

The Public-Private Hybrid of the American Welfare State

Despite the voluntary nature of privately sponsored pension plans, welfare policy is explicit in identifying private pensions as a part of the nation's scheme for income protection of the aged. Private income security plans are seen as one leg of the national three-legged stool for income protection in old age. Congress expects that private pensions will supplement Social Security benefits and individual savings to meet the economic needs of retirement. The yardstick accepted as adequate for income protection in retirement is a sixty to seventy percent replacement of pre-retirement income through Social Security, corporate pensions and personal savings.

Besides offering employers tax incentives to encourage collaboration with the state in achieving income protection for retirees, Congress has allowed employers to integrate private benefits with the expected Social Security benefits (Schultz and Leavitt, 1983). The integration of private plans with Social Security is a technical procedure which uses the projected Social Security pension as a base from which to establish the private pension benefit. This serves to unify the two systems to achieve an income formula that is considered adequate protection in retirement. From the perspective of Congress, integration is a technique which avoids the use of public funds to over-pension the retiree. From the perspective of the employer, it is a technique which guards against the lower-paid employee earning more during retirement than while working. Integration offers the employer the most dollar efficient means of funding income security plans. This publicly sanctioned method of establishing the retirement benefit also effectively ties the lower-paid employee to a lower-paid retirement check.

The integration of Social Security and private pensions creates an "interlocking" public and private partnership in a "hybrid" approach to a single income replacement goal for retirees (Root, 1982).

Congress has encouraged integration in recognition of the employer's contribution to Social Security (Schultz and Leavitt, 1983).

The social importance of corporate pensions to the welfare state is reflected in the income level of the ERISA plan beneficiaries. In 1983, 70 percent of these retirees had earned less than $25,000 annually. This was at a cost of $87.1 billion to the private sector. In economic terms the corporate pension system also has a significant impact on the nation. The financial assets tied up in the nation's pension trust funds in 1985 totalled 863 billion dollars. Clearly, corporate pensions are big business, and a business that protects the retirement income of many "ordinary" people (Andrews, 1985; Beam and McFadden, 1985; Kotlikoff and Smith, 1983).

Current Status of Pension Plans

From a financial standpoint, pensions are big business, but a business that is changing. The initiation of new pensions into the private sector decreased by 50 percent following the passage of ERISA. Before 1974, the number of plans was increasing at the rate of 15 percent per year, but by 1985 the rate of increase had slowed to 7 percent (Andrews, 1985). This concerns Congress at a time when Social Security assets, the welfare state's centerpiece for the income protection of retired citizens, are threatened. The problem is compounded by the knowledge that the older population is expected to reach 40.3 million by 2020 and will enjoy an extended retirement of seventeen years in contrast to the average duration of retirement in

1935 of 12.8 years (U.S. Congress, House, Committee on Economic Development, Reforming Retirement Policies, 1981; U.S. Congress, House, Special Committee on Aging, "Tenth Anniversary of the Employee Retirement Act," 1984).