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Toward Equalization of the Personal Retirement Savings Prerogatives of Small Business Owners and Their Employees

*Richard J. Kovach**

I. INTRODUCTION

The current pension taxation rules give employers almost sole discretion in determining whether employees will have substantial tax-favored retirement savings options. This power has resulted in the majority of employees in small businesses having no coverage under qualified retirement plans.¹ Giving employers the power to implement qualified retirement programs also resulted in retirement benefit coverage for some employees who would prefer that their plan contributions be paid as direct compensation, yielding them more immediate benefit.² Because only employers can sponsor most types of tax-favored retirement plans, many employees who desire substantial retirement savings cannot tax-effectively achieve their goals. Ironically, many other employees automatically accumulate retirement savings, irrespective of their current needs or desires. A rigid system that serves the needs of few, while complicating the lives of many, causes this inefficient situation.

Tax-favored individual retirement accounts permit earners to make direct annual contributions not in excess of \$2000, which is an exception to the general policy of employer control in the retirement

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1. In a speech before the San Francisco Actuarial Club on July 17, 1998, David M. Strauss, Executive Director of the Pension Benefit Guaranty Corporation, mentioned that 50 million Americans have no coverage under any employer-sponsored retirement plan, and that only eight percent of lower-wage workers, and just 20% of small business workers, have any retirement plan. See 1 Qualified Plan Alert No. 7, October 1998 (Panel Publishers). A tax favored, or "qualified" retirement plan, "is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer . . ." Treas. Reg. § 1.401-1(a)(2) (as amended in 1976).

2. Frequently, younger employees with children fall into this category of workers.

savings arena.³ The greater potential for tax-favored retirement savings, however, resides in employer-sponsored plans. These plans, at their best, provide some employees with retirement distributions for life well in excess of \$100,000 per year.⁴ The economic consequences of employer-sponsored retirement plans tend to attract business owners and other key personnel who strongly desire simultaneous tax relief and retirement income security. Despite this initial attraction, many employers decline to sponsor any retirement plans because of significant costs and technical complexities. When an employer does choose to sponsor a plan, the employer may take advantage of numerous rules in the pension taxation scheme that restrict coverage and contributions for common employees while allowing highly compensated participants to accrue substantial benefits.⁵

The owners of closely held businesses need not look solely to qualified retirement arrangements to provide themselves with tax-favored retirement savings. They can avoid the complexities, costs, and restrictions on economic freedom associated with formal pension arrangements while providing amply for their own retirement needs.⁶ The federal income taxation rules that govern the formation, growth, and disposition of business interests efficiently permit the owner of a closely held business to use the enterprise itself as a repository of value for future retirement needs. Consequently, many employees of small

3. See I.R.C. § 408(a)(1) (1994). The \$2000 annual contribution limit for individual retirement accounts appears paltry in comparison with the contribution limit of the lesser of \$30,000 per year or 25% of compensation permitted for qualified defined contribution plans sponsored by employers. See I.R.C. § 415(c)(1) (1994) (setting a different limit where employers sponsor retirement plans).

4. The \$30,000 per year limit of section 415(c)(1) of the Internal Revenue Code does not include earnings credited to the trust fund, which can boost total savings to millions of dollars and provide retirement payments that actually exceed an employee's annual earnings while employed. See I.R.C. § 415(c)(2) (1994); see also I.R.C. § 415(b)(1) (1994) (regarding accrued benefit limitations for qualified defined benefit plans).

5. For example, a sponsoring employer can prevent large numbers of employees from participating in a qualified retirement plan by taking advantage of various participation exclusions permitted under I.R.C. § 410(a) & (b). See I.R.C. § 410(a)-(b) (1994). One important exclusion allows an employer to automatically deny plan access to part-time employees who work fewer than 1000 hours per year. See I.R.C. § 410(a)(1)(A)(ii), (a)(3)(A) (1994).

6. Once an employer has excluded as many employees as it can under the participation coverage rules, the employer must cover the balance of its workforce or face plan disqualification. See I.R.C. § 410 (1994 & Supp. III 1997). Thus, the criteria for assigning qualified, deferred compensation result from the Internal Revenue Code's technical qualification features and do not derive solely from market conditions that might otherwise inform an employer's decisions when compensating individual employees. The employer that adopts a qualified retirement plan surrenders some of its economic freedom to tax regulation. See I.R.C. § 410 (1994 & Supp. III 1997) (discussing coverage exclusions under qualified retirement plans).

businesses have no formal retirement plan coverage partly because of the tax-favored savings features of business ownership itself. A comparison of the tax features of qualified retirement plans and business ownership reveals why, despite the many types of qualified retirement plans available to employers, so few rank and file employees of small businesses enjoy retirement plan coverage.⁷

Like qualified plans, business ownership and reinvestment offers retirement security for owners via income recognition deferrals, tax-sheltered value growth, and favorable taxation upon cashing out. Unlike qualified plans, business reinvestment does not involve compliance challenges, such as nondiscrimination and coverage rules, borrowing restrictions, and social protection structures pertaining to spousal rights, vesting, and spendthrift restraints. In deciding how to spend profits, small business owners often reject qualified plans in favor of business reinvestment, which offers them less complicated personal retirement security. Rather than alter either the tax advantages of business ownership or the key regulatory features of qualified plans, Congress should enhance the personal retirement savings prerogatives of employees through expanded opportunities to fund individual retirement accounts without employer consent.

II. HOW TAXATION BENEFITS OF BUSINESS REINVESTMENT COMPARE WITH TAXATION BENEFITS OF QUALIFIED RETIREMENT PLANS

The favorable income taxation features of qualified retirement plans are: immediately deductible contributions that employees do not recognize until actual distribution; deferral of income recognition on fund earnings; and mitigated distributions taxation. Devoting profits to business reinvestment, however, often produces equal or improved tax advantages.

A. *Income Recognition Deferral for the Business Owner*

In each year that business operations produce an excess of gross income over expenses, the business owner has to decide how to dispose

7. Qualified retirement arrangements include the following: defined benefit pension plans, money purchase pension plans, target benefit pension plans, cash balance plans, profit sharing plans, stock bonus plans, employee stock ownership plans, simplified employee pensions, and cash or deferred plans like the well known "401(k)" savings programs that have become so popular with larger employers. Congress recently added the Savings Incentive Match Plan ("SIMPLE" plan) to the list of employer-sponsored retirement arrangements. See Small Business Job Protection Act of 1996, Pub. L. No. 104-88, § 1421, 110 Stat. 1755, 1792-95 (codified at I.R.C. § 408(p) (1994)).

of the added value.⁸ If the business owner provides services within the business, compensation for these services represents an expense that affects the availability of profits to serve noncompensatory purposes that increase the value of the business.⁹ The owner of a controlling interest in a corporation, for instance, can become an employee of the corporation and set his salary so low that the owner's services have little cost to the corporation, or so high that the corporation incurs operating losses in order to allow the owner to enjoy a higher standard of living.¹⁰ Owners who either have outside sources of income or who deliberately restrict themselves to lower standards of living have a great deal of discretion in determining how much profit will remain with their businesses and thus increase the enterprise's value. Converting potential profitability into personal consumption tends to restrict the growth of an enterprise's value, while retaining profits in the business tends to turn the business into a steadily compounding form of personal savings for the owner, who trades immediate consumption for an increasing net worth. Owning a business surely tests one's tolerance for deferred gratification.¹¹

8. This added value does not necessarily comport with income taxation concepts of "gross income." See I.R.C. § 61(a)(2) (1994). Nor does it comport with the concept of business expense deductions. See generally I.R.C. § 162 (West 1988 & Supp. 1999) (outlining allowable general business expense deductions). Taxable income is another concept that is not synonymous with added value. See I.R.C. § 63 (1994 & Supp. III 1997). For example, economic income can include interest receipts exempt under I.R.C. § 103. See I.R.C. § 103(a) (1994) (excluding state and local bond interest from gross income). Tax deductions may include depreciation allowances granted under section 168 of the Internal Revenue Code even though the assets involved actually appreciate in value. See I.R.C. § 168(a) (1994) (providing for the depreciation of tangible property).

9. To achieve income tax deductions for compensation paid to a business owner who serves as an employee of a business, the compensation must not exceed the vague "reasonable allowance" standard imposed by section 162(a)(1) of the Internal Revenue Code, which sets at least a theoretical upper limit on the conversion of economic profits into deductible service payments. See I.R.C. § 162 (West 1988 & Supp. 1999) (outlining the parameters of self-employment deductions).

10. The owner of an unincorporated business can similarly extract a variable amount of the profits from the business for personal consumption without worrying about the extent of personal services rendered because a sole proprietor gets no deduction for an owner-related compensatory expense under section 162(a)(1) of the Internal Revenue Code. See I.R.C. § 162(l)(4) (1994) (discussing health insurance deductions for self-employed individuals). The proprietor cannot serve as both employer and employee for this purpose and can only deduct compensation paid to others who might serve as employees of the proprietor. See *id.* A partnership may deduct a compensatory payment for a partner's services if it designates the payment as a "guaranteed payment," even though this is a limitation of the general rule. See I.R.C. § 707(c) (1994). Otherwise, partnership income allocated to a partner will not produce a deduction under section 162(a)(1) of the Internal Revenue Code and, thus, need not relate to the extent of services rendered by a partner. See I.R.C. § 707(c) (1994).

11. Regular employees, especially in newer high technology firms, sometimes also are able to

The owner of a prosperous business may also create wealth by structuring a personal compensation package that includes contributions to a formal retirement savings plan.¹² The business owner who sets up a qualified retirement plan places faith in the growth potential of other businesses, as well as faith in the business personally controlled.¹³ The entrepreneur who diverts part of the bounty of the enterprise into a qualified retirement plan's investment portfolio makes an economic decision that the diverted money will ultimately produce more personal benefit than if the money went into either immediate consumption or the enterprise's present and future needs.¹⁴ This choice involves a cost-benefit analysis that requires comparing the needs of tomorrow with current business and personal demands.

The economic decision to favor current consumption, qualified retirement savings, or business growth must take into account the tax implications of each choice. If an owner chooses immediate consumption, income recognition will likely result, thereby reducing consumption to the net value remaining after income taxes are paid.¹⁵ If the owner chooses to divert profits into a qualified retirement plan, income recognition will not occur until the qualified plan's trust actually distributes assets to the owner.¹⁶ Deferred gratification

exercise their tolerance for deferred gratification (and risk) when their compensation packages include substantial stock options in lieu of immediate payments.

12. "Formality" here refers primarily to the voluminous and detailed qualification scheme for tax-favored retirement plans contained in section 401(a) of the Code. *See* I.R.C. § 401(a) (West 1988 & Supp. 1999).

13. Unlike investment in a personally controlled business, investment in a stock portfolio held in a qualified retirement plan cannot exceed specific annual limitations that constitute an important part of the qualification scheme under sections 415(b) and (c) of the Code. *See* I.R.C. § 415(b)(1) (1994) (setting benefits at the lesser of \$90,000 or 100% of the participant's average compensation from the last three years); I.R.C. § 415(c)(1) (1994) (setting contributions at the lesser of \$30,000 or 25% of the participant's compensation for the year).

14. In some instances, leaving profits in the business to serve future growth will not offer the best choice because of market exigencies. For example, the particular business might already have reached its maximum market share and face cost inefficiencies that prohibit expansion through operational diversification.

15. The owner has some power to mitigate compensatory tax consequences that would normally occur under section 61(a)(1) of the Code by taking advantage of a variety of employee fringe benefits that result in income exclusions. *See, e.g.*, I.R.C. § 105(b) (1994) (excluding reimbursements for medical expenses from gross income); I.R.C. § 106 (1994 & Supp. III 1997) (excluding employer contributions to accident and health plans from gross income); I.R.C. § 119 (West 1988 & Supp. 1999) (excluding the value of meals or lodging furnished for the employer's convenience from gross income); I.R.C. § 132 (West 1988 & Supp. 1999) (excluding listed fringe benefits from an employee's gross income). A business owner's status as an employee of a closely held corporation allows these exclusions to apply.

16. *See* I.R.C. § 402(a) (1994) (discussing the taxability of the beneficiaries of qualified trusts).

corresponds precisely with deferred income recognition. A participant in a qualified retirement plan normally reports no income with respect to plan contributions as long as they remain titled in the name of the plan's trustee.¹⁷

If the owner instead chooses to leave profits in the business in order to enhance its value, the owner's income recognition consequences more closely resemble those resulting from a qualified retirement plan contribution rather than the income tax consequences associated with current consumption.¹⁸ The precise tax effect to the owner as a result of leaving profits in the business will depend on whether the owner conducts the business in a separately taxed entity,¹⁹ and how the retained profits are applied toward business uses.²⁰ If a separately taxed corporation retains profits, its independent tax posture will determine the surrogate liability that the corporation's owner indirectly bears, especially to the extent that retained earnings correspond with corporate taxable income.²¹ If the small business is incorporated, retained earnings might result in either no additional taxable income to the entity,²² or taxable income that costs the entity no more than fifteen cents per dollar.²³ As a result, the effect of retaining \$30,000 in the business (as opposed to diverting the same \$30,000 to a qualified retirement plan)²⁴ need not result in significant additional income

17. Disqualification of a plan for failure to meet the lengthy requirements of section 401(a) of the Code spoils the tax-favored deferral of income recognition. *See* I.R.C. § 402(b) (1994) (discussing the taxability of the beneficiaries of nonexempt trusts).

18. *See generally* I.R.C. § 162 (West 1988 & Supp. 1999) (discussing the impact of business expense deductions).

19. Entities other than corporations can recognize income separately as a result of the "check the box" regulations. *See* Treas. Reg. § 301.7701-3 (1996) (allowing some unincorporated organizations to elect to be taxed as corporations).

20. Some business expenses will produce immediate offsetting deductions. *See* I.R.C. § 162(a) (1994 & Supp. III 1997). Other expenses, such as capital purchases that produce depreciation deductions under section 168, will defer offsetting deductions until later taxable years. *See* I.R.C. § 168 (West 1988 & Supp. 1999). Of course, the business owner can defer immediate deductions by letting retained earnings accumulate for subsequent purchases of goods or services that benefit the business.

21. The surrogate tax liability experienced at the entity level can involve favorable income taxation rate differences because of the separate rate table used for corporations under section 11. *See* I.R.C. § 11(b) (West 1988 & Supp. 1999) (providing the tax rate schedule for corporations).

22. The corporation might absorb additional taxable income associated with retained earnings into net operating losses carried over from prior years. *See* I.R.C. § 172(b)(1)(A)(ii) (1994 & Supp. III 1997) (allowing net operating loss carryovers "to each of the 20 taxable years following year of loss").

23. The marginal rate on the first \$50,000 of a corporation's taxable income is 15%. *See* I.R.C. § 11(b) (West 1988 & Supp. 1999).

24. *See* I.R.C. § 415(c)(1)(A) (1994) (stating that contributions are limited to \$30,000 or 25% of the participant's compensation).

recognition or tax cost for the business owner.²⁵ Diverting the same payment to personal consumption could result in a greater tax cost if the owner's income is taxed at higher marginal rates than those of the entity.²⁶

Even if the owner operates a small business as a proprietorship or as a pass-through entity like a partnership, S corporation, or limited liability company, the personal tax effect of diverting a potential retirement plan contribution to retained profits will at worst approximate the immediate tax effect of earnings devoted to personal consumption.²⁷ Unlike money taken for personal consumption, however, money retained in a business for future business uses has the potential to mitigate the business owner's future income tax liabilities.²⁸ Using retained profits later to make potentially deductible business expenditures will result in less future taxable income to the owner.²⁹ If the owner converts retained revenues into business expenditures in the same taxable year as the owner would otherwise have made a retirement plan contribution using the same money, retaining earnings will have a tax effect similar to that of a retirement plan contribution, as long as the business expenditures produce immediate deductions.³⁰

If the owner converts retained profits into business expenditures in later taxable years, the difference in income recognition consequences between a current plan contribution and retained profits becomes a matter of tax benefit deferral. The extent of the deferral depends on the business owner's informed discretion in timing the expenditures that

25. In addition to the plan contribution on behalf of the owner-executive, section 401(a) could require contributions on behalf of other employees, potentially making the plan more expensive to maintain than the income tax liability, if any, associated with retaining the earnings in the business. *See* I.R.C. § 401(a)(4) (West 1988 & Supp. 1999) (disallowing discrimination in favor of highly compensated employees).

26. *See* I.R.C. § 1(a)-(d) (West 1988 & Supp. 1999) (outlining the progressive tax rates for married individuals, heads of household, and unmarried individuals).

27. *See supra* note 20 (discussing the impact of deferred deductions).

28. Such investment would be treated as a business or capital expense. *See* I.R.C. § 162 (West 1988 & Supp. 1999).

29. In fact, the owner's deferral of deductible business expenditures might produce a greater marginal tax savings as a result of rate bracket shifts under the progressive impositions of sections 1(a)-(d). *See* I.R.C. § 1(a)-(d) (West 1988 & Supp. 1999). Expenditures for personal consumption produce no deductions. *See* I.R.C. § 262 (1994).

30. *Compare* I.R.C. § 168 (West 1988 & Supp. 1999) (providing for accelerated cost recovery for depreciation deductions), § 195 (1994) (providing for deductions that amortize an expense over a period of years), *and* § 197 (Supp. III. 1997) (involving the acquisition of business assets having a useful life beyond the current year), *with* I.R.C. § 162 (West 1988 & Supp. 1999) (providing for deductions for expenditures that pertain only to the current year).

frequently produce immediate tax deductions when paid or incurred.³¹ If the business owner's tax adviser gives careful thought to this discretionary timing issue, deferral of deductible expenditures from retained profits can produce tax savings if later deductions offset higher rate bracket income.³² Regardless of when retained profits turn into business expenditures, the income recognition effect of retaining profits more closely resembles that of deductible contributions to a qualified retirement plan than the tax effect of distributions to the owner for immediate consumption.

B. Economic Consequences to the Business Owner Before Deferred Gratification Turns Into Future Consumption

If a business owner funds a qualified retirement plan, the plan's trustee invests the contributions until future distributions are necessary. This produces economic benefits and taxation advantages that have helped popularize qualified retirement plans.³³ Economically, the participant hopes that compounded investment returns on plan contributions will create wealth that far exceeds any inflationary devaluation of plan assets. This hope has been a reality for many participants as domestic equities have increased in value beyond inflation for many years.³⁴ The small business owner who establishes a qualified retirement account might benefit more by investing in publicly traded businesses controlled by others than by putting the same money back into the enterprise.³⁵ With the uncertainty of equities markets in

31. For example, an owner has a great deal of discretion in deciding whether and when to replace equipment used in the business with more efficient models and whether and when to spend retained earnings on a marketing consultant who might help increase sales volume. An immediate deduction for the former might result under the election to expense certain depreciable business assets. See I.R.C. § 179 (1994 & Supp. III 1997).

32. The tax paid today might be based on a different tax rate than a tax paid later on the same amount of taxable income because of changes in the Internal Revenue Code or rate bracket variations resulting from the taxpayer's shifting tax and economic characteristics.

33. The economic advantages of prudent investment of plan contributions compound more efficiently as a result of the trust's freedom from income taxation. See I.R.C. § 501(a) (1994) (providing tax exemption for the trust of a qualified retirement plan).

34. The booming equities markets of the late 1990s underscored the importance of both investment diversification, as evidenced by the so-called "indexed" funds, and the patience necessary to outlast bear markets and take full advantage of bull markets. An owner's direct investment in a business frequently reflects these concepts as well. Diversification through aggregation of businesses, product lines, and goods/services combinations often accompanies a long-term commitment to business ownership that may span generations of owners.

35. On the other hand, a failure to devote sufficient reinvestment into the directly-owned operation might jeopardize its future stability to the extent that retirement plan contributions must diminish or cease despite the benefits of investment diversification offered through retirement plan accumulations. Plan contributions do not yield greater investment diversification if the busi-

today's global business environment, however, many small business owners will choose to reinvest in their own businesses.

Some owners of closely held businesses will view qualified retirement plan investments as an opportunity to diversify total investments into a personally controlled component (the closely held business itself) and a broader component that places faith in the economic growth potential of leading domestic corporations.³⁶ Other owners, especially those who sense the growth potential of their own endeavors, will prefer to devote all their capital to the expansion of the source of wealth in which they have far greater control, knowledge, and interest. This will happen at the expense of investment in the efforts of other entrepreneurs. Instead of worrying about the Dow Jones average and which particular stocks will likely excel in the future, many small business owners choose to focus all their energies on optimizing their entrepreneurial choices.

Money applied toward the growth of a closely held business tangibly can offer more excitement, satisfaction, and self-affirmation than if left to feed a retirement plan that is dependent on the incomprehensible value fluctuations of publicly-held entities. Thirty thousand dollars *not* put into an owner's retirement account³⁷ could provide an incentive for an underpaid, rising star salesman who might double the business's sales. That person might otherwise jump ship to a competitor and take key customers along for the ride. The same money could purchase a new machine in anticipation of expanded production, initiate an advertising campaign that brings in dozens of new customers, or pay a retainer to a patent attorney who pursues an otherwise dormant infringement claim.³⁸

ness owner cannot afford them due to the poor economic health of the "goose that lays the golden egg." Reinvestment in the business often provides the goose's staple diet.

36. Sometimes the choice does not manifest as an "either/or" selection but rather becomes a matter of choosing a proper mix between plan contributions and reinvestment in the business. For this reason, small employers who do implement a qualified retirement plan often prefer to sponsor a profit-sharing plan under section 401(a), which allows them to determine how much to contribute from year to year as an exercise of their business discretion. *See* I.R.C. § 401(a) (West 1988 & Supp. 1999). By contrast, qualified pension plans create fixed future funding liabilities as a result of the requirement that the plans systematically pay definitely determinable benefits. *See* Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 1976) (stating that pension plans "provide systematically for the payment of definitely determinable benefits . . . over a period of years, usually for life, after retirement").

37. The contribution to a qualified retirement plan on behalf of an owner might exceed \$30,000 annually if the plan is a defined benefit plan. *See* I.R.C. § 415(b)(1) (1994). *But see* I.R.C. § 415(c)(1) (1994) (concerning limitations on defined contribution plans).

38. To the extent any of these expenditures enhance the overall value of the business, the owner can increase the potential future capital gain resulting from a later disposition of the busi-

Prudent reinvestment in a small but growing business under the owner's direct control not only serves ownership, but also boosts employment and the economy in general.³⁹ Thus, the temptation to divert discretionary profits into pension plan contributions can lead to an unintended implication of qualified plan policy. Economists can argue the relative efficiencies of consumption versus savings in advancing our national economy, but the relative efficiencies of small business reinvestment versus investments in publicly traded securities can produce just as lively a debate.⁴⁰ Regardless, many small business owners, given the choice to place a limited amount of unconsumed profits into either a qualified retirement plan or their own enterprise, will choose the latter because of the perception that they will have greater economic control and future growth prospects.

*C. Tax Consequences to the Business Owner Before and Upon
Cashing Out*

The trust of a qualified retirement plan normally does not pay income tax on earnings it realizes from investments of contributions.⁴¹ The qualified plan's trust will be subject to tax only if income results from the direct active conduct of a business or otherwise falls under the unrelated business income tax rules.⁴² Neither an employer's contributions to the trustee nor the trust's investment earnings cause income recognition to the trust's beneficiaries until the trustee actually distributes money or other property from the trust.⁴³ Unlike other

ness and thereby secure a preferential rate of taxation. See I.R.C. § 1(h) (West 1988 & Supp. 1999) (defining capital gains rates). Plans holding contributions invested in equities that appreciate in value actually convert appreciation otherwise taxed as capital gain into ordinary income taxed at higher rates as a result of I.R.C. § 402(a) and its incorporation by reference of section 72, which taxes plan distributions as though they came from annuities and not capital assets. See *infra* notes 52-55 and accompanying text (discussing characterization of gains from various dispositions).

39. Forty million Americans work in enterprises that have 100 or fewer employees. See Ellen E. Shultz, *Small-Company Pensions Spur Lawmakers' Concern*, WALL ST. J., July 14, 1999, at C1.

40. In 1999, an interesting question for market pundits pertained to whether stocks in popular American companies had values determined more by demand and investor psychology than by economic fundamentals.

41. See I.R.C. § 501(a) (1994) (providing tax exemption for the trust of a qualified retirement plan).

42. See I.R.C. §§ 511-514 (West 1988 & Supp. 1999) (providing for the imposition of taxes on certain exempt organizations' business income).

43. See I.R.C. § 402(a) (1994) (discussing the taxation of an employee trust's beneficiary). Likewise, income realizations in individual retirement accounts are not subject to tax until distributed. See I.R.C. § 408(d)(1) (1994). Income taxation results only if plans fail to meet the technical requirements of their respective qualification schemes. See, e.g., I.R.C. § 402(b) (1994)

compensatory receivables, a qualified plan's accrued benefits do not cause income recognition under the doctrine of constructive receipt because merely making distributions available under a plan does not amount to actual distribution of plan benefits.⁴⁴

Leaving discretionary profits in the business that produced them tends to enhance the value of the business in indiscernible increments that do not convert to income realizations until the owner disposes of an interest in the business.⁴⁵ Because economic realization must precede taxation when property, including a business interest, changes ownership, a business owner not under a prior contractual restraint has complete discretion in timing income recognition from the disposition of a business interest.⁴⁶ Accordingly, a business owner's power to control both the disposition of an interest and resulting income recognition parallels the distribution recognition feature of qualified retirement plans. At least three differences, however, actually favor business interests over qualified retirement benefits.

First, a business interest disposition can occur more freely than distributions from a qualified retirement trust. A retirement trust's qualification strictures often include rules that preclude plan distributions until certain designated events have happened, such as death, disability, retirement, or other separation from service.⁴⁷ These strictures apply even if the business owner owns 100% of the employer that sponsors a qualified plan and even if the business owner owns the plan's only accrued benefit.⁴⁸

(discussing the taxability of the beneficiaries of nonexempt trusts).

44. See I.R.C. § 402(a) (1994) (stating that "any amount *actually* distributed . . . shall be taxable to the distributee . . ." (emphasis added)). When Code section 402(a) used the words "distributed or made available," it allowed constructive receipt applications, which potentially occurred prior to 1982. This transition from taxation of "available" amounts to amounts "actually distributed" occurred under the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 314(c), 95 Stat. 172, 286 (1981).

45. Although an unwise investment in a closely held business could diminish its value, unwise investments in a qualified retirement trust could similarly diminish accrued benefits. One glaring difference in this comparison results under the fiduciary responsibility rules imposed under section 404 of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829, 877 (1974). Bad investments in a qualified retirement plan can not only hurt an owner-participant, but all other plan participants as well. Declining values thus invite scrutiny for possible claims that the plan administrator and trustee have breached their fiduciary duties.

46. See I.R.C. § 1001(a) (1994) (defining the computation of gain or loss from the sale or disposition of property).

47. See, e.g., I.R.C. § 401(k)(2)(B)(i) (1994) (listing events that trigger section 401(k) plan distributions).

48. A one-participant plan could result where the plan sponsor is properly using only the services of independent contractors instead of employees, thus leaving only the owner of the business with the status of an eligible participating employee. A qualified retirement plan cannot

Second, the qualified plan scheme forces a participant/business owner to commence taking distributions soon after reaching age seventy and one-half despite any contrary desire to continue income recognition deferral.⁴⁹ On the other hand, a business owner need not wait until a technically required event's occurrence before disposing of an interest in the enterprise. The owner can hold on to an interest until death. Again, the rigidity of the qualified plan undermines its value as a retirement option for closely held business owners, and by extension helps to preclude common employees from optimum retirement savings.

Third, those business owners who hold on to their interests until death create a distinct income taxation advantage for their estates or other beneficiaries who subsequently dispose of the business. Although the capital gain otherwise resulting from a business interest disposition can disappear altogether with the assignment of a date-of-death valuation basis,⁵⁰ income recognition confronts the beneficiaries of a decedent's qualified plan interest because of an "income in respect of a decedent" rule.⁵¹ Under this rule, a surviving beneficiary who gets a qualified retirement account takes the decedent's basis in the account (often zero) and thus reports substantial income upon distribution of the account, because the distribution represents income the decedent had a right to prior to death. To the contrary, a surviving beneficiary who gets appreciated stock outside of a qualified retirement account can sell the stock with a stepped-up basis equal to its value at the time of the decedent's death and consequently avoid the gain recognition that otherwise would occur with the decedent's lower basis.⁵²

Furthermore, although cashing out an appreciated interest in a business before death often produces capital gain, qualified plan distributions, whether made before or after the plan participant's death,

cover workers who do not have the status of *employees*. See I.R.C. § 401(a)(2) (1994) (requiring that a trust be used for the "exclusive benefit" of employees or their beneficiaries).

49. See I.R.C. § 401(a)(9)(A), (C) (1994 & Supp. III 1997) (providing that the required beginning date is April 1 of the calendar year following the later of the year the employee turns age 70 or when the employee retires).

50. See I.R.C. § 1014(a)(1) (1994 & Supp. III 1997) (setting the basis of an asset at its fair market value at the decedent's death).

51. I.R.C. § 1014(c) (1994) (disallowing the fair market value at death basis rule when a beneficiary receives income in respect to a decedent); see also I.R.C. § 691 (1994 & Supp. III 1997) (defining the concept of income in respect of a decedent).

52. Inter vivos transfers of appreciated business interests made gratuitously, however, do not afford a fair market value date-of-transfer basis, which is allowed for testamentary dispositions. See I.R.C. § 1015(a) (1994) (providing generally that a donee takes the donor's basis for gifted property).

frequently generate ordinary income payments as from an annuity.⁵³ Investment assets earned within a qualified plan's trust, whether produced by dividends, interest, rents, royalties, or capital appreciation upon sale of securities held in the trust's portfolio, are ultimately subject to tax at rates up to 39.6%.⁵⁴ Long term capital gains, on the other hand, are taxed at lower preferential rates.⁵⁵ In effect, a qualified plan operates like a financial machine that silently converts capital appreciation into ordinary income as a by-product of income recognition deferral.

Only in very limited circumstances does a qualified plan produce the desired product without the undesired side effect. If a qualified plan distributes appreciated securities issued by the plan's sponsoring employer, the participant can eventually recognize the "net unrealized appreciation" from the securities as capital gain.⁵⁶ In addition, a participant born before 1936 might recognize a portion of a lump sum distribution as capital gain subject to a fixed twenty percent tax rate if the participant's plan participation predates 1974.⁵⁷ Although not specifically allowing a rate reduction in the guise of capital gains taxation, for twenty-five years Internal Revenue Code § 402(d) permitted participants receiving qualifying lump sum distributions to use an income averaging mechanism to reduce the effective rate of taxation.⁵⁸ Unfortunately, most participants in qualified retirement plans cannot take advantage of income averaging for lump sum distributions after 1999. Plan distributees will incur full taxation under ordinary income rates, except in special situations involving direct distributions of employer securities or lump sum distributions to now-older participants

53. See *supra* note 38 (explaining that distributions from qualified plans, which are invested in capital assets that appreciated in value, are taxed as ordinary income rather than as capital gain). Cashed-out business interests normally constitute capital assets under I.R.C. § 1221. See I.R.C. § 1221 (1994) (listing properties that are not capital assets).

54. See I.R.C. § 1(a)-(d) (West 1988 & Supp. 1999) (defining the normal income tax liability structure for individuals of different filing statuses).

55. Code section 1(h)(1)(C) imposes a general capital gains rate of taxation that does not exceed 20% of a taxpayer's adjusted net capital gain. See I.R.C. § 1(h)(1)(C) (West 1988 & Supp. 1999).

56. See Treas. Reg. § 1.402(a)-(1)(b)(1)(i)(b) (1960).

57. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1122(h), 100 Stat. 2085, 2470-71 (1986).

58. The Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2005(a), 88 Stat. 829, 987 (1974) ("ERISA") introduced ten-year income averaging for qualified plan lump sum distributions. The Tax Reform Act of 1986, Pub. L. No. 99-514, § 1122(a), 100 Stat. 2085, 2466 (1986), reduced the averaging period from ten years to five years. The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1401(a), 110 Stat. 1755, 1787 (1996), repealed five-year income averaging effective for the years beginning after December 31, 1999.

who accrued service before 1974.⁵⁹

By contrast, disposition of a business interest frequently qualifies for a capital gain's preferred rate of taxation.⁶⁰ Higher rates can result, but such a result would be an exception, just as qualified plan distributions sometimes fit into low rate exceptions.⁶¹ The owner of an incorporated business would likely have held his interest sufficiently long that favorable capital gains taxation would result upon disposition of the stock.⁶² Small business owners normally experience growth in the value of their stock over a period of many years. Whether the entrepreneur exchanges stock in a sale, swap, redemption, or liquidation, a long-term capital gain usually results.⁶³

The owner of a proprietorship will recognize ordinary income upon disposition of a business only to the extent a portion of the sale proceeds reflects disposition of particular ordinary income assets, such as inventory or accounts receivable. Other assets used in the business and goodwill built up over the years will produce the more desirable long-term capital gain for a sole proprietor.⁶⁴ Accordingly, the tax benefits of reinvesting in a proprietorship impair an employee's chance of having an employer-sponsored retirement plan.

59. See Small Business Job Protection Act of 1996, § 1401(c)(2) at 1789.

60. A disposition of appreciated stock in a closely held corporation would result in capital gains taxation because the stock would likely fit the definition of a capital asset. See I.R.C. § 1221 (1994) (defining a capital asset for the purpose of determining capital gains and losses).

61. Respecting a stock disposition, a higher rate of taxation would result if the owner did not hold the stock for the holding period necessary to produce the net capital gain rate preference under section 1(h). See I.R.C. § 1222(11) (West 1988 & Supp. 1999) (defining "net capital gain" with reference to "net long-term capital gain," which involves holding a capital asset for more than one year). Respecting direct dispositions of business assets under unincorporated forms of ownership, ordinary income assets, like inventory, would produce ordinary gain that is taxed at higher rates. See I.R.C. § 1221(1) (1994) (defining inventory as other than a capital asset).

62. If the owner holds the stock for more than five years, the stock might meet the definition of "qualified small business stock" and thus qualify for a 50% exclusion from gross income when the owner disposes of the stock and realizes a gain. See I.R.C. § 1202 (West Supp. 1999). Holding stock for at least one year ("long-term" under section 1222) qualifies the stock for "net capital gain." I.R.C. § 1222(11) (West 1988 & Supp. 1999). This permits the taxpayer to receive the preferential rate. See I.R.C. § 1(h)(1) (West 1988 & Supp. 1999).

63. Redemptions of stock can produce the desired tax result if they meet the rules of section 302, which distinguishes redemptions that should, by their substance, result in proceeds taxed as dividends. See I.R.C. § 302 (1994) (defining the conditions under which a corporation's redemption of its stock shall be treated as a distribution in part or in full payment for the stock).

64. See I.R.C. § 1221 (1994) (defining a capital asset for the purpose of determining capital gains and losses); I.R.C. § 1231 (West 1988 & Supp. 1999) (defining the conditions under which gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion of such property, shall be considered as capital asset gains or losses).

The owner of a partnership interest can incur some recognition of ordinary income depending on whether the partner disposes of the interest in a sale or liquidation. An appreciated partnership interest sold or exchanged to a new or existing partner will produce capital gain recognition for the disposing partner.⁶⁵ An exception, which parallels the recognition results for a disposing sole proprietor, exists to the extent that the proceeds reflect an underlying disposition of unrealized ordinary income receivables or partnership inventory.⁶⁶ A blend of tax consequences occurs when a retiring or deceased partner's interest is liquidated and payments from the entity to the withdrawing member follow. This blend can include: a tax-free return of basis, ordinary income recognition due to the partner's underlying interests in inventory, accounts receivable, or sometimes goodwill, and capital gain recognition attributable to the partner's underlying interest in assets that would produce capital gain if sold by the partnership.⁶⁷

In general, a disposing partner's conglomeration of recognition consequences upon disposition of a partnership interest lets him or her fare no worse than participants of a qualified plan upon receiving distributions of accrued benefits. Qualified plan distributions can involve a tax-free return of basis⁶⁸ and even capital gains in the special cases previously mentioned. The most likely tax consequence from plan payments, however, remains ordinary income recognition because plan distributions have the predominant character of realizations of compensatory receivables accrued for past services rendered.⁶⁹ Partnership interest dispositions, by contrast, frequently afford greater opportunities for capital gains recognition as a result of the value attributable to the subject enterprise's goodwill.⁷⁰

65. See I.R.C. § 741 (1994) (providing that the gain or loss in the sale or exchange of a partnership interest shall be recognized to the disposing partner and is considered as the gain or loss of a capital asset, except as specified in section 751 regarding unrealized receivables and inventory).

66. See I.R.C. § 751 (West 1988 & Supp. 1999) (defining the conditions under which proceeds from receivables and inventory are considered non-capital asset property).

67. See I.R.C. § 736 (West 1988 & Supp. 1999); Treas. Reg. § 1.736-1 (1960) (defining the conditions under which payments made in liquidation of a retiring or deceased partner's interest shall be considered as a distribution, a distributive share, or a guaranteed payment).

68. See I.R.C. § 72(c)(1), (f) (West 1988 & Supp. 1999) (providing rules for computing amounts invested in a particular plan).

69. See I.R.C. § 1221(4) (1994) (noting that the definition of capital asset does not include accounts receivable acquired in the ordinary course of business for services rendered).

70. Pursuant to Code section 736(b)(2)(B), a partnership's payments in liquidation of a departing partner's interest for goodwill of the partnership can result from a deemed exchange. See I.R.C. § 736(b)(2)(B) (West 1988 & Supp. 1999). This permits capital gain recognition as long as the partnership agreement provides for a payment with respect to goodwill. See *id.* Thus,

In any event, a small business owner who wants to insure that the disposition of his interest will completely avoid ordinary income recognition can always choose to incorporate rather than conduct business as a partnership or other entity, like a limited liability company, which invokes partnership tax consequences.⁷¹ Regardless of the business owner's entity choice for conducting business, the income recognition deferral possibilities respecting long-term growth of the business and the potential to obtain a low rate taxation on disposition proceeds favor allocating profits to business reinvestment rather than qualified retirement plan contributions.

III. ADDITIONAL BENEFITS OF THE DE FACTO RETIREMENT SCHEME FOR SMALL BUSINESS OWNERS

The income taxation features of qualified retirement plans involve a number of rules that mandate contributions for rank and file employees, restrict a sponsoring employer's access to retirement funds, and cause loss of tax advantages (disqualification) if plan administrators do not carefully observe social protections against certain alienations of accrued benefits. Business reinvestment, however, allows a business owner to accumulate wealth for retirement without these complications.

A. *Reinvestment of Profits Avoids Nondiscrimination Rules, Forced Coverage, and Mandated Contributions for Rank and File Workers*

Not only can a small business owner achieve better tax benefits than those offered under qualified plans by simply keeping profits in the business itself, but the owner can also avoid the complicated qualification scheme of formal retirement plans while still providing *personal* retirement income security from future disposition of the business.⁷² One of the most important rules of the retirement plan

partnership agreements commonly include a clause designating liquidation proceeds in exchange for goodwill, in order to prevent treatment of such payments as distributions of ordinary partnership income. See I.R.C. § 736(a)(1) (West 1988 & Supp. 1999) (defining conditions under which payments made to a retiring or deceased partner shall be considered as a distributive share or guaranteed payment).

71. Incorporation need not result in payment of entity income tax. Aside from Subchapter S status governed by Code sections 1361-1378, which may eliminate any entity level tax otherwise applicable, corporations operating small businesses frequently eliminate income tax liability by making sufficient deductible outlays to cause their taxable income to fall to zero. See I.R.C. § 162 (West 1988 & Supp. 1999) (allowing for deductibility of various business expenses).

72. The qualification scheme of section 401(a) spans 34 paragraphs of technical requirements, but some of these paragraphs incorporate by reference entire other sections of the Internal Revenue Code. See I.R.C. § 401(a) (West 1988 & Supp. 1999). For example, the vesting rules designated under section 401(a)(7) could not fit into a mere paragraph under subsection (a) and thus

qualification scheme prohibits economic discrimination that benefits highly compensated employees⁷³ to a greater extent than nonhighly compensated employees.⁷⁴ Through voluminous and complex Treasury regulations, this principle requires periodic testing to determine whether rank and file employees in a qualified plan fare proportionately as well as their better paid colleagues.⁷⁵

This nondiscrimination principle requires a calculation of how many employees in a particular company must participate in a qualified plan during a year.⁷⁶ The participation rules of the qualified plan scheme grant several exemptions that sponsoring employers can use to minimize coverage obligations.⁷⁷ Most employers, however, must incur at least some coverage costs on behalf of non-highly compensated employees in order to secure the privilege of including owners and other managerial or professional employees in their retirement plans.⁷⁸ Once a sponsoring employer determines its mandatory plan participants, yet another set of rules can require minimum contributions on behalf of a technically defined group of rank and file participants known as “non-key employee[s].”⁷⁹

These discrimination strictures and their attendant cost implications become serious impediments to the establishment of a qualified retirement plan covering the owner and other highly compensated employees of an enterprise. A business owner who forgoes contributing a portion of profits to a qualified plan in order to increase business reinvestment achieves personal retirement security through a more valuable business for later disposition and avoids these discrimination strictures.⁸⁰ The only risk in not implementing a qualified retirement

appear instead as section 411. *See* I.R.C. § 401(a)(7) (West 1988 & Supp. 1999). A business owner who uses the business itself as a form of retirement savings avoids the morass of complexity that plagues formal retirement arrangements. *See* I.R.C. § 401(a) (West 1988 & Supp. 1999).

73. Section 414(q) defines “highly compensated employee” as a person with at least five percent ownership of the employer sponsoring the plan or as any employee earning in excess of \$80,000 per year. *See* I.R.C. § 414(q) (West 1988 & Supp. 1999).

74. *See* I.R.C. § 401(a)(4) (West 1988 & Supp. 1999).

75. *See* Treas. Reg. § 1.401(a)(4) (as amended in 1993).

76. Section 401(a)(3) incorporates section 410, which defines the minimum participation standards for qualified retirement plans. *See* I.R.C. § 401(a)(3) (West 1988 & Supp. 1999).

77. *See supra* note 5 and accompanying text (identifying one such exemption permitted under Code section 410, which allows an employer to exclude part-time employees who work less than 1000 hours per year).

78. *See* I.R.C. § 410(b) (West 1988 & Supp. 1999).

79. *See* I.R.C. § 416(c)(2) (West 1988 & Supp. 1999).

80. In some instances, the existence of a qualified retirement plan can actually diminish the value of a business because prospective buyers might discount the business’ value if they view the plan’s future funding as a substantial liability.

plan is the failure to diversify retirement resources through the investment of plan funds in a broad array of marketable securities.⁸¹ This risk, however, is mitigated because even if an entrepreneur puts all retirement eggs in one basket, the entrepreneur personally holds that basket's handle and is not at the mercy of the poor investment judgment of others.

In addition to assuring her own retirement security, an enterprise owner can easily address the retirement income security needs of important executives, managers, or other key personnel by either awarding them non-controlling interests in the business⁸² or setting up non-qualified deferred compensation arrangements that need not adhere to the discrimination rules that plague qualified arrangements.⁸³ In this way, a business owner can acquire and retain highly skilled and productive employees without offering a qualified retirement savings device as a special inducement. Because non-qualified arrangements do not attempt to achieve taxation advantages beyond mere recognition deferral for future income promised, an employer can design specialized plans that cover only one executive at a time without compliance with the many qualification rules of Internal Revenue Code § 401(a).

A business owner can generally hire and retain non-key employees simply by offering a competitive wage without addressing their retirement income security needs beyond mandatory contributions to the Social Security system.⁸⁴ If, however, these less powerful employees wish to build retirement income security for themselves beyond the relatively modest payments granted under the Social Security system, they, unlike their employer, have very limited discretion in deciding whether and how to establish a tax-favored device to serve their needs.⁸⁵

81. Some qualified retirement plans—stock bonus plans, for instance—provide only minimal investment diversification because they involve large amounts of securities issued by the sponsoring employer. *See* Treas. Reg. § 1.401(b)(1)(iii) (1956).

82. *See* I.R.C. §§ 421-424 (West 1988 & Supp. 1999) (regarding income tax treatment for stock options granted by employers).

83. *See* Rev. Rul. 60-31, 1960-1 C.B. 174-81 (discussing the doctrine of constructive receipt as applied to certain deferred compensation arrangements).

84. Even if these employees participate in a qualified retirement plan by taking into account Social Security contributions under a complex process known as Social Security "integration," their employer may lessen contributions to the plan on their behalf. *See* I.R.C. § 401(l) (West 1988 & Supp. 1999).

85. Outside of a \$2000 annual contribution to an individual retirement account permitted under section 408(a), a worker who wants to participate in a retirement arrangement under section 401(a), but whose employer does not sponsor a plan would have to cease employment and become an independent provider of services. Then the worker would have to set up a qualified plan for herself, assuming the role of an employer. Two problems hinder this approach: first, the worker must personally incur the expense and complexity of plan sponsorship; second, and more

Under the current system for qualified retirement arrangements, the lower level employees' predicament can result directly from their employer's ability to achieve personal retirement income security outside of qualified plans. This inherent conflict of interest is unlikely to change so long as employers can only help their employees at the employer's expense.

B. The Qualified Retirement Plan Scheme Restricts a Business Owner's Access to Capital

In addition to qualified plan restrictions on the timing of distributions,⁸⁶ a business owner who chooses to invest surplus profits in a qualified retirement plan faces numerous complex rules that restrict the ability of plan participants to borrow from their accrued benefits.⁸⁷ Most importantly, an entrepreneur who builds up a substantial accrued benefit in a qualified plan, perhaps exceeding \$1,000,000, can borrow no more than \$50,000 at a time against that benefit without incurring prohibitory tax consequences.⁸⁸ A substantial diversion of profits into a qualified retirement plan thus restricts access to capital that might temporarily benefit an enterprise.

On the other hand, profits retained to enhance the value of a business permit the owner to obtain increasing amounts of outside credit as the business grows.⁸⁹ The owner can borrow considerably more than the \$50,000 permitted under the qualified plan rules from outside sources. In some instances, retained profits in the business might be liquid enough to allow self-financing and avoidance of borrowing altogether.⁹⁰

significantly, the recipient of the worker's services would have to surrender sufficient control over the worker to create a status of independence and might not be willing to do so, short of discharging the worker altogether.

86. See *supra* note 49 and accompanying text (noting that the rules for a qualified plan require a plan participant or owner to begin taking distributions at a specified age); see also I.R.C. § 72(t) (West 1988 & Supp. 1999) (imposing a penalty tax against qualified plan distributions made too early).

87. See, e.g., I.R.C. § 4975(a), (c)(1)(B), (d)(1) (West 1988 & Supp. 1999) (prescribing a penalty tax on prohibited transactions, which include the lending of money or extension of credit from a plan to a person who is defined as "disqualified" under particular circumstances).

88. See I.R.C. § 72(p)(2)(A) (West 1988 & Supp. 1999).

89. Interest expense deductions pertaining to outside business debt add an economic enhancement not always available when borrowing in the qualified retirement plan context. The deductions otherwise permitted under sections 163(a) and 163(h)(2)(A) do not benefit a business owner who properly borrows from the owner's accrued benefit in a qualified plan. See I.R.C. § 72(p)(3) (West 1988 & Supp. 1999).

90. Accumulated corporate earnings that meet the "reasonable needs of the business" standard of section 535(c)(1) would escape the accumulated earnings tax imposed under section 531. See I.R.C. § 535(c)(1) (West 1988 & Supp. 1999) (defining "reasonable needs of the business"); see also I.R.C. § 531 (West 1988 & Supp. 1999).

Either way, by directly using retained profits or by borrowing against value augmentations attributable to retained profits, the enterprise owner achieves better access to self-generated capital in choosing to leave earnings in the business than by diverting them to a qualified plan.⁹¹

When an entrepreneur needs additional capital to expand market opportunities, hire key personnel, acquire new facilities and equipment, develop new technology, or acquire intellectual property, past profits put into a qualified retirement plan will offer little assistance. On the other hand, past profits kept in the business help accelerate continuous expansion by offering a ready pool of capital. Contributions to qualified retirement plans diminish the pool of available capital because qualification restrictions prevent the sponsoring employer from using the plan's assets for business purposes.⁹² Again, an employer's profit-making interests directly conflict with an employee's interests in saving for retirement.

In one respect, retirement plan contributions devoted to workers other than owners may constitute a form of reinvestment in the business.⁹³ This is the case because compensatory enhancements, either immediate or deferred, can lead to increased productivity, retention of valuable employees, and an overall better position for the employer in labor markets. These advantages do enhance the value of a business. Nevertheless, the qualified retirement plan scheme contains so many diverse restrictions on how, when, and to whom plan benefits accrue that serious questions arise with respect to the economic efficiency of qualified retirement arrangements. The value-enhancing employment effects that clearly result from more direct, immediate compensatory awards are easier and less costly to implement than a retirement plan.

Direct compensatory awards produce their desired results through linking the hiring, retention, and productivity of *particular* employees with *specific* monetary incentives. These incentives fluctuate circumstantially under bonus programs, salary scales, job classification

91. A business owner could only borrow against the owner's personal interest in a qualified retirement plan. Borrowing from the interests of other plan participants would violate the "exclusive benefit" rule of section 401(a)(2) and thus disqualify the plan. See I.R.C. § 401(a)(2) (West 1988 & Supp. 1999).

92. See I.R.C. § 401(a)(2) (West 1988 & Supp. 1999).

93. Almost all qualified retirement plans involve substantial employer contributions. Even "cash or deferred" arrangements under section 401(k) frequently involve employer matching contributions in addition to employee contributions. Matching contributions encourage elective participation and thus help a 401(k) plan meet its "deferral percentage" tests. See I.R.C. § 401(k)(3) (West 1988 & Supp. 1999).

structures, and other arrangements that an employer can design, alter, or terminate nearly at will.⁹⁴ Although a sponsoring employer can exercise some flexibility in making formal deferred compensation allocations that selectively and conditionally reward particular employees,⁹⁵ heavy regulation prevents qualified retirement plans from serving as the best way for an employer to structure compensatory incentives.

For example, an employer who skews contribution allocations under a qualified profit-sharing plan according to a formula that rewards production attainments would have to monitor and potentially adjust results under the formula each year in order to avoid disqualification of the plan under the discrimination rules.⁹⁶ Similarly, an employer could not indefinitely suspend contributions to a profit-sharing plan in the face of a long-term decline in workforce productivity without retroactively jeopardizing the plan's qualification status.⁹⁷ Additionally, the qualification scheme's participation rules could require coverage of more workers than the number of employees for whom special incentives would produce measurable effects on workforce productivity and stability.⁹⁸ Because of the coverage and allocation rules of the qualified retirement plan scheme,⁹⁹ compensatory incentives that do not include qualified retirement plans offer greater efficiency.

94. The primary limitations against these implementations usually relate to employee morale problems, union agreements, or the threat of unionization.

95. A sponsoring employer could carefully select categories of employees who do not participate in a qualified plan as long as the total number of excluded employees does not offend the applicable statutory exclusion computations. See I.R.C. § 410(b)(A)-(B) (West 1988 & Supp. 1999) (defining the minimum coverage requirements that a qualified plan must meet).

96. See Treas. Reg. § 1.401(a)(4)-2, 3 (as amended in 1993). Disqualification would result if the formula generated inordinately favorable allocations for highly compensated employees. The definition of production attainment would have to change to accommodate nonhighly compensated employees. A formula that stressed sales increases and cost attainments might have to account better for "blue collar" factors like unit production and hours worked. If after such a change the formula still inordinately rewarded highly compensated employees, further adjustments would have to occur in a following year. If, thereafter, rank and file participants started to receive inordinately large allocations, additional fine-tuning of the formula could occur in yet a later year, and so on until the employer realized a correct balance.

97. See I.R.C. § 411(d)(3)(B) (West 1988 & Supp. 1999).

98. Some jobs do not readily permit effective use of special incentives. Compare janitorial and file clerk positions with production and sales jobs.

99. See *infra* Part III.C (discussing the social agenda aspects of the qualified retirement plan scheme).

C. The Social Agenda of a Qualified Plan Presents Employers with Additional Problems and Disincentives

Qualified retirement plans must comply with many rules in addition to those that impose limitations on the employer's access to capital and mandate coverage and contributions under discrimination precepts. Internal Revenue Code § 401 and the Employee Retirement Income Security Act of 1974 ("ERISA")¹⁰⁰ include a variety of regulatory impositions designed to make sponsoring employers agents for the enforcement of social principles that reflect how Congress thought pension arrangements should operate. This is an added hurdle to an already difficult mechanism that only ends up harming many of the employees it was meant to protect.

Many qualified retirement plans require administrators to monitor benefit dispositions to a participant's beneficiaries in order to protect the interests of surviving spouses.¹⁰¹ As a default rule, a qualified plan usually must provide a residual benefit for a surviving spouse at least equal to one-half of the benefit available to a plan participant prior to death.¹⁰² A participant who wishes to name a beneficiary other than a surviving spouse must secure formal, written consent from the participant's spouse.¹⁰³ The duties of keeping track of beneficiary designation changes, implementing detailed procedures for excluding a spouse with consent, and taking into account changes in the marital status of plan participants fall directly upon the plan administrator, and thus indirectly on the plan's sponsoring employer.¹⁰⁴

Because lack of enforcement of the joint and survivor payment rules can lead to plan disqualification and serious tax consequences for both employer and plan participants,¹⁰⁵ these rules indirectly force an

100. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974).

101. See I.R.C. § 401(a)(11) (West 1988 & Supp. 1999) (defining the conditions under which joint and survivor annuities and pre-retirement survivor annuities are payable under a qualified plan).

102. See I.R.C. § 417(b) (West 1988 & Supp. 1999) (defining the qualified joint and survivor annuities under section 401(a)(11)).

103. See I.R.C. § 417(a)(2) (1994) (requiring that an election to waive the joint and survivor annuity be in writing, designate a beneficiary, and acknowledge the effect of the election).

104. Like all features of the qualification scheme, both the expense of compliance *and* risk of noncompliance eventually fall on the sponsoring employer and thus discourage plan sponsorship.

105. See I.R.C. § 402(b)(4) (1994) (regarding the income tax consequences of a disqualification to the plan participants); I.R.C. § 404(a)(5) (1994) (regarding the sponsoring employer's possible loss or deferral of deductions for plan contributions). Further, the trust of a disqualified plan would lose its tax exemption. See I.R.C. § 501(a) (1994) (providing qualified retirement trusts with exemption from taxation).

employer to involve itself in the social implications of its employees' testamentary dispositions. This is arguably a concern for which a business owner has neither time nor interest. Accordingly, a business owner can personally provide for retirement income security in a way that involves consideration of only the owner's testamentary desires by avoiding implementation of a qualified retirement plan and directing profits back into the business.

Qualified plans also interfere with the ability of an employee to contract with an employer regarding the terms and conditions of employment. Outside of qualified retirement arrangements, however, an employer can offer "restricted property" to an employee willing to suffer a forfeiture upon failing to achieve certain productivity or service goals.¹⁰⁶ Forfeiture arrangements can benefit both employer and employees by creating extraordinary rewards for sustained efforts clearly defined prior to designated periods of service. For example, an employer could compensate an employee with employer securities endorsed with special restrictions that require a surrender of the securities in the event the employee fails to provide continuous service for a designated period, attain sales quotas, or increase revenues in a unit of the business.

Contingent deferred compensation, however, must comply with complex vesting standards when awarded in the context of a qualified plan.¹⁰⁷ An employer cannot offer contributions or benefits under qualified arrangements for any contingency except mere accrual of service, and the periods of service required must conform with statutory limitations.¹⁰⁸ These detailed standards present an employer with yet another regulatory morass easily avoided by simply foregoing sponsorship of a qualified retirement plan. Although the social protection purpose implicit in the vesting rules might assist weak employees from submitting to unreasonable compensatory contingencies, it hinders employees who might willingly accept a wide range of contingencies in order to obtain extraordinary compensatory

106. The tax consequences of employer-provided restricted property occur under I.R.C. § 83, which generally precludes income recognition to the employee until any substantial risk of forfeiture with respect to the property (usually stock in the employer) contractually disappears. *See* I.R.C. § 83 (1994).

107. *See generally* I.R.C. § 411 (1994) (stating that in a qualified trust an employee's right to benefits be nonforfeitable upon attainment of designated periods of service).

108. Section 411 allows employers to use any vesting schedule that fits within one of two paradigms. One offers complete vesting on an all-or-nothing basis after five years of service and the other mandates full vesting after seven years with partial vesting in earlier years. *See* I.R.C. § 411(a)(2) (1994).

advantages in the future.¹⁰⁹ Furthermore, even weaker employees fail to benefit if qualification complexities and restrictions cause large numbers of employers to shun formal deferred compensation arrangements.

Another socially-motivated qualification feature interferes with a participant's freedom to contract with creditors. A set of nonalienation rules effectively create a spendthrift trust for qualified plans.¹¹⁰ Ostensibly, the nonalienation qualification requirement saves plan officials from dealing with demands against the retirement fund asserted by creditors of participants. To the extent the nonalienation restriction applies, the policy implications of protecting participants against their own spendthrift tendencies in order to better preserve retirement income security comport well with the employer's convenience in providing unimpeded plan administration.¹¹¹ The spendthrift principle, however, does not uniformly apply to all creditors. Certain exceptions to the nonalienation rule can cause considerable complexity in plan administration.¹¹² One difficult exception invokes a set of ancillary rules pertaining to "qualified domestic relations orders," which can force plan officials to turn over all or a portion of a participant's accrued benefit to a former spouse.¹¹³ A plan official presented with a domestic relations payment order must first check to verify that the order indeed fulfills the technical criteria that make it "qualified."¹¹⁴ Because the order, even if qualified, cannot alter the timing or form of distributions from the plan,¹¹⁵ the trustee and plan administrator must place the order

109. For example, vesting outside the qualified plan might occur upon reaching certain productivity goals, educational standards, or skills development. Section 411 permits forfeitures of accrued benefits only for failure to attain requisite service time. *See* I.R.C. § 411(a)(1) (1994).

110. *See* I.R.C. § 401(a)(13) (1994). A spendthrift trust prohibits most creditors from receiving any benefit.

111. Presumably, plan administrators enjoy their ability to ignore attachment orders from local courts, even though an inadvertent, ministerial observance of such an order might threaten a plan's qualification and create a claim to restore the portion of an accrued benefit paid under the order.

112. *See* I.R.C. § 401(a)(13)(A) (1994) (permitting voluntary assignments of up to 10% of any benefit payment made to a plan participant). The Treasury regulations also permit enforcement of federal tax obligations against a participant's accrued benefit. *See* Treas. Reg. § 1.401(a)-13(b)(2) (as amended in 1988); *see also* I.R.C. § 401(a)(13)(C) (West 1988 & Supp. 1999) (regarding enforcement relating to judgments from a crime involving the plan).

113. I.R.C. § 401(a)(13)(B) (1994) (allowing alienation pursuant to a qualified domestic relations order).

114. *See* I.R.C. § 414(p) (1994) (defining a qualified domestic order as an order that "creates or recognizes the existence of an alternative payee's rights to, or assigns an alternative payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan").

115. *See* I.R.C. § 414(p)(3) (1994) (restricting the order to the amount, form, and payee that

into the plan's institutional memory for later execution and keep track of the alternate payee for the time remaining until permitted distributions occur.¹¹⁶

The various rules implementing social policies for qualified plans do not endear prospective plan sponsors to formal retirement savings arrangements.¹¹⁷ These rules at the very least create additional agency costs for employers.¹¹⁸ At worse, inadvertent violations of these voluminous and complex edicts can jeopardize the very retirement income security goals the qualification scheme presumably supports because adverse tax deficiencies resulting from a disqualification, including interest and penalties, can devastate both employers and participating employees.¹¹⁹ The more the regulatory scheme attempts to force employers to protect employees, the greater the disincentive for employers to adopt qualified retirement plans. Because many employers exercise their unrestricted choice to avoid these plans altogether, millions of American workers have no access to substantial retirement savings arrangements.¹²⁰

A decision to forgo adoption of a qualified retirement arrangement in no way precludes a business owner from personally providing for his own retirement because enterprise reinvestment so frequently produces wealth for the owner under tax-favored circumstances. Absent an imprudent confiscation of business ownership interests under a new wealth redistribution approach, the collective decisions of thousands of

has been previously determined by the plan).

116. Some kinds of qualified retirement plans can only make distributions upon the occurrence of certain events. *See supra* note 47 and accompanying text (referring to plans that designate death, disability, retirement or other separation of service as occurrences for distribution).

117. Nor do the seemingly nonsocial economic rules of the qualification scheme help popularize qualified retirement plans among employers. *See* I.R.C. § 401(a)(17) (1994) (prohibiting a plan from taking into account the compensation of any employee above \$160,000 per year). Owners with annual compensation above \$160,000 must structure their benefit or contribution formula in a way that does not fully reflect their own compensation levels, thus either relatively reducing their personal accrued benefits or increasing the plan costs with respect to other participants. *See* I.R.C. § 401(a)(17)(B) (1994) (establishing the original compensation cap at \$150,000 per year with an allowance for cost of living increases).

118. A service industry has evolved to address the problems of qualified retirement plan administration. This industry includes not only lawyers and accountants, but also actuaries, appraisers, financial planners, insurance consultants, investment advisers, and teams of in-house and independent professional administrators.

119. *See supra* note 105 (regarding the tax consequences of disqualification, including loss of tax exempt status).

120. The employers who must adopt and maintain a qualified retirement arrangement do so under contractual restraints, such as collective bargaining agreements. Of course, elements of contractual freedom in the negotiation process suggest that even these employers have the ultimate power to avoid qualified plans.

privately controlled employers will continue to disfavor even modest wealth accumulations for common workers.¹²¹ Owners find business reinvestment a beneficial way to fund their own retirements while avoiding complex social purpose regulation, practical restrictions on access to capital, and forced coverage and funding associated with qualified retirement savings programs.

IV. POLICY IMPLICATIONS OF THE DE FACTO RETIREMENT SCHEME FOR SMALL BUSINESS OWNERS AND A PROPOSAL FOR CHANGE

Under current law, small business owners have superior prerogatives for enhancing their personal retirement security. Their employees, however, cannot attain substantial tax-favored retirement savings without the cooperation of the owners. Rather than reducing the choices of employers, Congress could best narrow the retirement savings gap by giving employees new opportunities to fund individual retirement accounts on their own.

A. Altering the Advantages of Business Reinvestment Would Not Solve the Problem of Retirement Savings Availability

If reinvestment by small business owners did not result in significant tax advantages, entrepreneurs might find the tax advantages of qualified retirement plans much more attractive by comparison. More business owners would turn to qualified plans in order to provide efficiently for their own retirements and obtain immediate tax relief through contribution deductions¹²² and income recognition avoidance.¹²³ This option, however, has serious drawbacks.

To make business reinvestment relatively inefficient, Congress would have to remove substantial tax advantages, such as the capital gains rate preference,¹²⁴ the lower corporate rate brackets that comparatively shelter modest earnings accumulations in closely held corporations,¹²⁵

121. Even die-hard proponents of wealth confiscation understand some of the practical limitations of "killing the goose that lays the golden eggs." Wealth confiscation attempts can cause an exodus of talent and resources that ultimately destabilizes an economy.

122. See generally I.R.C. § 404 (1994) (limiting deductions for contributions paid by an employer under a stock bonus, pension, profit-sharing or annuity plan).

123. See I.R.C. § 501(a) (1994) (allowing an exemption from taxation for qualified retirement trusts); I.R.C. § 402(a) (1994) (providing for the taxation of any amount distributed to the distributee from a tax-exempt qualified retirement trust).

124. See I.R.C. § 1(h) (West Supp. 1999) (setting forth preferential rates for capital gains).

125. See I.R.C. § 11 (1994). Note that under section 11(b)(2), the advantage of the lower corporate rate brackets does not extend to certain personal service corporations. See I.R.C. § 11(b)(2) (1994).

the broad deductibility of business expenditures,¹²⁶ and the stepped-up basis rule that eliminates latent gain on a business interest held until the owner's death.¹²⁷ Historically, these tax features have been enhanced, not restricted or abolished.¹²⁸ Therefore, unless the forces that promote tax advantages for businesses somehow weaken significantly in coming years, the tax advantages associated with business reinvestment likely will remain intact.

Political power alone does not account for the continued popularity of tax advantages for business reinvestment. These advantages arguably contribute to the strength of the general economy, particularly in its capacity to sustain appropriately high levels of employment.¹²⁹ Accordingly, policy makers must consider whether opposition to tax advantages for small businesses might cause more harm than good.¹³⁰ To promote retirement income security for workers who do not own businesses, labor advocates, who oppose tax advantages favoring business reinvestment, must act carefully. If they assert that removing tax incentives for business reinvestment would encourage business owners to sponsor qualified plans, these labor advocates might inadvertently stifle employment opportunities. Diverting direct investment in small businesses to indirect investment in publicly traded securities held in qualified retirement plans could reduce hiring in small businesses while further energizing securities markets that probably do not need additional artificial growth incentives.¹³¹

126. Congress would have to amend provisions of the Internal Revenue Code like sections 162, 168, and 179 to make them much more restrictive. See I.R.C. § 162 (1994) (allowing a deduction for all ordinary and necessary expenses paid or incurred in carrying on any trade or business); I.R.C. § 168 (1994) (permitting depreciation deductions for tangible property); I.R.C. § 179 (1994) (allowing immediate deductions for depreciable business assets). Any such limiting mechanisms would likely add complexity to the Code, invite loophole explorations, and intensify lobbying for a reversal of policy.

127. See I.R.C. § 1014(a)(1) (1994) (defining the basis of assets received from a decedent as the fair market value at the date of the decedent's death).

128. Note that the allowance for "bonus depreciation" under section 179(b)(1) increases steadily through the year 2003. See I.R.C. § 179(b)(1) (West Supp. 1999).

129. See *supra* note 39 and accompanying text (supporting the argument that reinvestment boosts employment rates and the economy in general).

130. By the late 1990s, many European countries, which generally impose higher levels of taxation and regulation on businesses than does the United States, struggled with high unemployment levels while the U.S. economy enjoyed historically low unemployment rates.

131. One nonartificial growth factor affecting the stock market boom of the late 1990s resulted from the economic maturation of the "baby boom" generation (born between 1946 and 1964), who invested huge amounts of wealth in domestic securities.

In addition to shifting capital from direct business investment to publicly traded securities,¹³² shutting down tax advantages for business reinvestment might produce at least two kinds of adverse reactions from business owners. First, employers and their advisers would want to vigorously probe existing technical possibilities for reducing qualified plan contribution and coverage costs respecting nonhighly compensated employees.¹³³ Second, employers would just as vigorously push for new legislation altering the qualified plans scheme to expand benefits for owners and other highly compensated employees while restricting costs attributable to rank and file employees.¹³⁴ The net effect of these adverse reactions would not advance the retirement income security needs of workers who have no control over the businesses that employ them. Qualified plans would continue to become increasingly complex, and small employers would still resist implementing retirement savings devices that require substantial additional costs not corresponding with increased productivity or expanded business opportunities.¹³⁵

B. Altering the Qualified Plan's Scheme to Allow All Employees to Establish and Fund Their Own Comparable Arrangements Would Best Promote Retirement Savings Access

Although destroying tax incentives for business owners to reinvest in their businesses would likely produce hardships for both employers and employees, simply shifting the power to implement substantial tax-favored retirement arrangements from employers to employees would benefit both groups. If Congress removed the \$2000 limitation on annual contributions to individual retirement accounts, any employee

132. Outside of stock purchases under initial public offerings, capital invested in stocks usually only transfers value between buyers and sellers of such investments who have no substantial say in company management. Owner investment of capital in closely held businesses involves economic transfers that directly stimulate business activity under the guidance of those who most intimately understand the efficient applications of such capital. A very important policy question is whether the taxation scheme should stimulate the former kind of capital transfers (represented by qualified retirement plan portfolios) while discouraging the latter capital transfers, which directly stimulate the growth of small businesses.

133. The easiest way to do this might involve outsourcing labor (perhaps to foreign countries) or getting rid of regular employees in favor of temporary employees and independent contractors.

134. For example, employers might push to broaden the participation exclusions available under section 410. See I.R.C. § 410 (1994) (providing minimum participation standards).

135. The nondiscrimination concept expressed in I.R.C. sections 401(a)(4) and 410(b) only distinguishes broad categories of employees depending on whether they have "highly compensated employee" status. See I.R.C. § 401(a)(4) (1994); I.R.C. § 410(b) (1994). Thus, the qualification scheme does not directly permit an employer to match deferred compensation awards with the efforts, skills, knowledge, and productivity of individual workers in a workforce. See *supra* notes 94-99 and accompanying text (arguing that direct compensatory incentives are more efficient than costly retirement plans).

desiring substantial retirement savings could freely effect income recognition deferrals without the necessity of an employer-sponsored plan.¹³⁶ Abolishing all restrictions on the deductibility of contributions to individual retirement accounts would also help.¹³⁷ Employees would have unfettered access to tax-favored retirement income security, and employers would no longer need to assume paternalistic and costly control over their employees' retirement savings prospects.

Altering the current qualified plans scheme in this manner would create the equivalent of a universal "cash or deferred" arrangement—a nationally sponsored "401(k)" plan.¹³⁸ Employees working in the majority of small businesses that sponsor no qualified plan would not have to forgo serious retirement planning simply because their employers decide that qualified plans offer too few advantages to justify the bother and costs. Like business owners themselves, common employees would have an attractive tax-favored choice for fulfilling their retirement planning goals without the inconvenience of having to account for the retirement planning circumstances of others. A business owner could create personal retirement security through expansion of the enterprise that produces the owner's current livelihood. Likewise, under an expanded individual retirement account program, any worker could, while saving taxes, transform a substantial portion of current income into additional security for the future. Neither business owners nor common workers would have to worry about the retirement needs of fellow workers, cost elements beyond their control, or the numerous complications of an overregulated retirement scheme.¹³⁹

Although many rank and file workers whose employers offer no qualified plans do not take advantage of their ability to fund an individual retirement account even to the parsimonious extent currently permitted, all workers could potentially benefit from an expansion of self-funding retirement options. Any worker can experience economic changes over a career that warrant at least temporary funding of a tax-

136. See I.R.C. § 408(a) (1994) (defining an individual retirement account as "a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries").

137. See I.R.C. § 219(g) (1994) (limiting individual retirement account deductions for individuals participating in pension plans).

138. This suggests that the contribution limit for individual retirement accounts should rise from \$2000 to at least the statutory limit for elective deferrals under section 401(k) plans contained in section 402(g)(1). See I.R.C. § 402(g)(1) (1994). Currently, this limit sets the maximum elective deferral per participant per year at \$10,000. See I.R.S. Notice 97-58, 1997-2 C.B. 309.

139. Compare I.R.C. § 408 (1994) (regulating individual retirement accounts), with I.R.C. § 401(a) (1994) (including all Code sections incorporated by reference within the latter, underscoring the relative simplicity of I.R.C. § 408).

avored retirement plan.¹⁴⁰ These changes include improved compensation, economic emancipation from obligations to support children as they grow older, marriage to a spouse who has assets or potential earning capacity, eventual payment of long-term debts, and serendipitous relief from financial need.¹⁴¹ Even if ultimately unexercised by many workers, the opportunity to effect tax-favored retirement savings beyond a mere \$2000 per year¹⁴² without reliance on the good graces of a sponsoring employer would enhance the financial planning prospects of the entire national workforce.¹⁴³

Concerns that highly compensated employees would take undue advantage of a universal program that permitted substantial, self-actuated retirement contributions need not deprive the rest of the workforce of their personal opportunities to provide for future income security. Congress could always control the revenue leak from an expansion of self-funding opportunities by phasing in lower dollar limitations on individual retirement account contributions when an employee's income exceeds a designated amount or an employee already receives substantial retirement funding from an employer. Additionally, business owners themselves would not necessarily take full advantage of expanded, self-funding opportunities because reinvestment in one's own business often provides more attractive economic prospects, and sometimes even better tax benefits, than investing in qualified retirement plans. If freed from the regulatory burden of qualified plans, many business owners likely would still prefer to plough all earnings not needed for current consumption back into the enterprise that serves simultaneously as a source of current income and as a retirement nest egg.¹⁴⁴

140. Expanded opportunities for funding individual retirement accounts would work best if Congress would also amend section 408 by including a "catch up" provision that permits even greater contributions for workers who do not commence retirement savings until later in life.

141. Serendipitous financial relief can come in many forms, including an inheritance, unanticipated increases in the value of a home, or an unexpected promotion at work.

142. In 1974, when section 408 appeared, Congress set the contribution limit for individual retirement accounts at \$1500 per year. *See* Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2002, 88 Stat. 829, 959 (1974) (codified at I.R.C. § 220).

143. Psychologically, expanded retirement savings opportunities for all could lead to greater participation because those who do start saving for the future tend to add new life to a workplace culture. For instance, once an employer implements a section 401(k) plan, those who initially make elective deferrals pique the interests of those who initially do not by mentioning their account balances, talking about their investment choices, and making known their retirement plans or wishes.

144. As developed throughout this Article, the business owner reaps personal tax benefits by either reinvesting in the business or by contributing to a qualified retirement plan. Consequently, business owner participation in an expanded individual retirement account scheme should pro-

The category of highly compensated employees includes better paid employees who do not own or control their employers.¹⁴⁵ Many highly compensated employees work for larger employers that sponsor qualified retirement plans already permitting substantial retirement savings.¹⁴⁶ Many other managerial and professional employees do not fare so well. No sound policy reason exists to prevent any highly compensated employee working for a nonsponsoring employer from having a basic choice to create substantial tax advantaged retirement savings. Access to universal retirement savings makes sense for all workers. Encouragement of personal retirement savings without artificial distinctions based on earnings would increase the national savings rate, create a climate of personal financial responsibility, and free all employees from the adverse consequences of their employers' decisions not to sponsor formal retirement savings arrangements.¹⁴⁷

V. CONCLUSION

A business owner's first impulse upon discovering that enterprise operations have produced profits in excess of what the owner needs for personal consumption often leads to a decision to retain excess earnings within the business that produced them. Given the complexities, social edicts, and open-ended costs associated with qualified retirement plans,¹⁴⁸ business owners frequently give formal retirement plan contributions a low priority and sometimes even prefer personal consumption as a better use for excess earnings. The preference for business reinvestment becomes even more compelling when business

duce relatively neutral overall tax effects.

145. See I.R.C. § 414(q)(1) (West 1988 & Supp. 1999) (defining a highly compensated employee as any employee who was a five percent owner or had compensation in excess of \$80,000). Many employees earning more than \$80,000 per year have no ownership interest in their employers.

146. An expanded individual retirement account scheme need not include all workers. Those who already receive substantial benefits from a qualified retirement plan could have their annual individual retirement account limitation reduced dollar-for-dollar, down to the current limitation of \$2000 under section 408(a), by amounts contributed from time to time on their behalf under section 401(a) arrangements.

147. If an expanded individual retirement account scheme based on section 401(k) plan contribution limitations appeared too costly from a tax revenue viewpoint, Congress could set the precise limitation on annual contributions downward for *both* individual retirement accounts *and* other qualified plans until the revenue leakage from all tax-favored retirement savings vehicles reached a point of fiscal and political tolerance.

148. Expanding workforces tend to make qualified retirement plan costs open-ended due to the participation coverage edicts of section 410. See I.R.C. § 410 (1994) (specifying the minimum participation standards necessary to constitute a qualified trust).

owners and their advisers contemplate the many federal income taxation benefits associated with reinvestment.

These tax benefits include immediate deductibility of many business expenditures¹⁴⁹ and long-term capital gains rate preferences, which compare quite favorably with the tax benefits resulting from sponsorship of a qualified retirement plan.¹⁵⁰ More pointedly, enterprise reinvestment allows entrepreneurs to enjoy these tax benefits while providing personally for their own retirements by adding economic value to their growing concerns rather than enhancing potential accrued benefits in a qualified retirement arrangement.¹⁵¹

Reinvestment in the enterprise competes all too well with contributions to formal retirement plans. Tax benefits, value growth, and freedom from superfluous costs and excess regulation make business reinvestment attractive enough to cause a large majority of small business owners to avoid tax-favored retirement savings arrangements. Many small employers refuse to sponsor qualified retirement plans simply because they offer insufficient benefits compared to business reinvestment. These owners prefer reinvestment strategies that yield relatively little regulatory interference and substantial direct personal control.¹⁵²

Because removing the tax benefits of business reinvestment would likely produce too great an overall economic detriment while producing tremendous political resistance, the best approach for solving the lack of access to retirement savings for employees in small enterprises requires changing the current retirement savings structure to permit employees to assume direct plan sponsorship power. By expanding every employee's possibilities for deferring compensation into self-settled, tax-favored

149. See *supra* note 30 and accompanying text (discussing the similar tax effect the conversion of retained revenues into business expenditures will have compared with making contributions to retirement plans).

150. The comparison between tax benefits for business reinvestment and qualified retirement plans suggests that legislative policy has somewhat equally encouraged both retirement income security and the employment/business growth enhancements necessary to provide for American workers until they retire.

151. Most importantly regarding personal funding for retirement income security, a business owner who uses reinvestment of profits to promote growth of the enterprise experiences no limitations on contributions or benefits similar to those imposed under sections 415(b) and (c) for qualified retirement plans. See I.R.C. § 415(b) (1994) (limiting annual benefits); I.R.C. § 415(c) (1994) (limiting contributions).

152. Reinvesting profits to add value to the business not only offers a good retirement approach for the owner, but also affords more efficient compensation planning for the entire workforce. Compensation expense directed toward qualified retirement plans is steered inefficiently. See *supra* note 135 and accompanying text (arguing that the qualification scheme does not allow employers to match the efforts of workers).

accounts, common workers would have choices for retirement savings closer to those now enjoyed only by business owners.

The current tax climate that allows business reinvestment to serve as a de facto retirement plan for owners explains why eighty percent of small business employees have no coverage under employer sponsored retirement plans.¹⁵³ To correct this problem, Congress should dissolve the marriage between access to substantial retirement savings and the unrestrained prerogative of employers. Serious tax-favored retirement savings should not come from on high but should result, if at all, from the prerogative of those who would voluntarily seek to enhance their retirements beyond the provisions of the Social Security system.

153. See *supra* note 1 (explaining that 50 million Americans have no coverage, only eight percent of low wage earners have coverage, and only 20% of small business workers have retirement plans).