

## CALIFORNIA DREAMING: THE CALIFORNIA SECURE CHOICE RETIREMENT SAVINGS TRUST ACT

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*Half of American workers are not covered by employer-sponsored retirement arrangements. The recently passed California Secure Choice Retirement Savings Trust Act seeks to solve this problem by mandating retirement savings arrangements for California employers, coupled with a public investment vehicle for investing these private retirement savings. The Act is important because of California's size and status as a trendsetter for other states.*

*This Article is the first to examine the important legal questions the Act raises under the Internal Revenue Code and ERISA. Contrary to the drafters' intent, the savings accounts authorized under the Act do not qualify as individual retirement accounts under the Code. Hence, employees participating in savings arrangements established under the Act will not receive the income tax benefits associated with individual retirement accounts.*

*If the Act were to be amended to make its accounts individual retirement accounts, the Act would survive ERISA preemption under New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co., 514 U.S. 645 (1995), though not under Shaw v. Delta Air Lines, Inc., 463 U.S. 85 (1983). Since Travelers is the Court's more recent and more compelling construction of ERISA preemption, the Act should survive ERISA preemption if the Act is amended to have true individual retirement accounts.*

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*A final section of this article addresses the choices other state legislatures, as well as Congress, confront if they elect to follow part or all of the path on which California has embarked to encourage private retirement savings. President Obama has recently proposed a federal mandate under which employers with more than ten employees would be required to maintain either retirement plans or IRA coverage. The President's proposal ensures public debate about the appropriate function of government in encouraging retirement savings. The Golden State's Act will play an important role in that debate. In that debate, I favor state-by-state experimentation rather than any single approach to the task of encouraging greater retirement savings.*

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## I. INTRODUCTION

By signing the California Secure Choice Retirement Savings Trust Act (“the Act”), Governor Edmund (“Jerry”) Brown, Jr. took an important step toward establishing a retirement savings mandate for Golden State employers, coupled with a public investment vehicle for private retirement savings.<sup>1</sup> By simultaneously signing S.B. 923,<sup>2</sup> Governor Brown guaranteed further debate about the Act and its provisions since S.B. 923 requires an additional vote of the California legislature before the Act can be implemented.<sup>3</sup> The Act represents the first tentative success of nationwide efforts to create state-sponsored private retirement programs.<sup>4</sup>

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<sup>1</sup> S.B. 1234, 2012 Leg., Reg. Sess. (Cal. 2012); see Laura Mahoney, *California Governor Signs Bills to Create Pension Mandate for Private Employers*, DAILY TAX REP. (BNA) No. 190, at H-2 (Oct. 2, 2012).

<sup>2</sup> S.B. 923, 2012 Leg., Reg. Sess. (Cal. 2012); Mahoney, *supra* note 1.

<sup>3</sup> See S.B. 923 2012 Leg., Reg. Sess. § 2 (Cal. 2012) (adding § 100043.5 to the CAL. GOV'T CODE (2013)).

<sup>4</sup> See Florence Olsen, *California Leads, No State Has Green Light For State-Based Private Retirement Accounts*, PENSION & BENEFITS DAILY (BNA) (Aug. 7, 2013). For examples of other states' efforts, see Brent Hunsberger, *Oregon House Passes Bill to Examine Statewide Retirement Savings Plan*, OREGON LIVE (June 24, 2013), [http://www.oregonlive.com/finance/index.ssf/2013/06/oregon\\_house\\_passes\\_bill\\_to\\_ex.html](http://www.oregonlive.com/finance/index.ssf/2013/06/oregon_house_passes_bill_to_ex.html); National Conference of State Legislatures, *State Sponsored Retirement Savings Plans for Non-Public Employees*, <http://www.ncsl.org/issues-research/labor/state-sponsored-retirement-plans-for-nonpublic.aspx> (last visited Jan. 24, 2014).

The Act is important, not only because of California's size and status as a trendsetter, but because the task the Act addresses is pressing: increasing the retirement savings of the half of American workers not currently covered by employer-sponsored retirement arrangements.<sup>5</sup>

I write to explore the legal status of the Act, in particular the Act's standing under the Employee Retirement Income Security Act of 1974 (ERISA)<sup>6</sup> and the Internal Revenue Code (Code).<sup>7</sup> The Act raises three important questions under ERISA and the Code: Are the accounts established by the Act individual retirement accounts for purposes of the Code? Does ERISA preempt the employer mandate established by the Act? Does ERISA preempt the Act's provisions authorizing supplemental employer contributions to employees' accounts established under the Act? The drafters of the Act were acutely sensitive to all three of these questions.<sup>8</sup>

The accounts created by the Act do not qualify as individual retirement accounts under the Code. The hallmark of an individual

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<sup>5</sup> DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS 124 (Apr. 2013) ("Tens of millions of U.S. households have not placed themselves on a path to become financially prepared for retirement. In addition, the proportion of U.S. workers participating in employer-sponsored plans has remained stagnant for decades at no more than about half the total work force . . .").

<sup>6</sup> ERISA was originally adopted as the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) and has repeatedly been amended. Many provisions of ERISA were adopted twice, once as tax law additions to the Internal Revenue Code and once as additions to Title 29 of the United States Code, enforced by the Department of Labor. It is today customary to refer to the labor provisions codified in Title 29 as "ERISA" and to refer to the tax provisions of ERISA by their respective designations in the Internal Revenue Code. This article follows this convention. On the dual tax/labor structure of ERISA, see JOHN H. LANGBEIN ET AL., PENSION AND EMPLOYEE BENEFIT LAW 97 (5th ed. 2010).

<sup>7</sup> 26 U.S.C. § 1 (2006).

<sup>8</sup> See S.B. 1234, 2012 Leg., Reg. Sess. § 3 (Cal. 2012) (adding § 100043 to the CAL. GOV'T CODE (2012) (program not to be implemented "if it is determined that the program is an employee benefit plan under" ERISA or if the employees' accounts under the program "fail to qualify" as IRAs) and §§ 100004(e) and 100012(k) (supplementary employer contributions to be permitted only if such contributions "would not cause the program to be treated as an employee benefit plan under" ERISA)).

account for retirement planning purposes is the direct and unmediated assignment to the account holder of the rewards of good investment performance and the costs of investment loss. In contrast, the accounts created under the Act are notional in nature, formula-based cash balance-style defined benefit claims against a collective trust fund. These notional accounts are credited with an assumed rate of return determined before the beginning of the year, regardless of the Trust's actual investment experience during the year. The Trust established by the California Act (not the individual employee/account holder) bears investment risk and is liable for underfunding. The formula-based, cash balance-style accounts created by the Act do not qualify under the Code as individual retirement accounts as these accounts will not be decreased to reflect investment losses and will not directly benefit from current investment gains.

Suppose, however, that the Act is amended to make its accounts individual retirement accounts for purposes of Code § 408 by shifting investment reward and downside to the account holder. In this case, the ERISA preemption status of the Act's employer mandate reflects the Court's contradictory guidance on ERISA preemption: ERISA § 514(a)<sup>9</sup> preempts the Act's employer mandate under *Shaw v. Delta Air Lines, Inc.*<sup>10</sup> but not under the Court's later decision in *New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co.*<sup>11</sup> Since *Travelers* is the Court's more recent and more persuasive approach to ERISA preemption, *Travelers* should control. Thus, assuming amendment of the Act to convert the Act's accounts into individual retirement accounts, the Act's employer mandate should not be ERISA-preempted.

My conclusion is similar as to the third legal issue raised by the Act, whether ERISA preempts the provisions of the Act which authorize supplementary employer contributions to employees' accounts established under the Act: this provision of the Act is ERISA-preempted under *Shaw* but survives § 514(a) scrutiny under *Travelers*' more recent, more flexible, and more compelling approach to ERISA preemption.

In light of the foregoing, if *Travelers* controls (as it should), the Act could, as a legal matter, be salvaged by recasting the Act's accounts as individual retirement accounts under which the employee/individual account holders bear investment risk and thus benefit directly from

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<sup>9</sup> 29 U.S.C. § 1144(a) (2006).

<sup>10</sup> See 463 U.S. 85, 91 (1983).

<sup>11</sup> See 514 U.S. 645, 701 (1995).

investment gains and incur the costs of investment losses. However, as the Act is currently structured, the Act fails muster under the Code because the notional accounts created by the Act do not qualify as individual retirement accounts.

There is, thus, a road map for amending the Act to make it Code and ERISA-compliant under *Travelers*: reformulate the accounts established under the Act as individual retirement accounts with investment reward and investment loss assigned to the account holder, rather than the current notional, formula-based design of the Act's accounts. However, under *Shaw*, there is no equivalent road map. Since *Travelers* is the Supreme Court's more recent and more convincing approach to ERISA preemption, the Act should be salvageable by converting its accounts to individual retirement accounts that allocate investment gain and loss to the account holders.

This Article first outlines the Act and then identifies five noteworthy features of the Act including the Act's linkage of its employer mandate for retirement savings with a public investment vehicle for those savings as well as the Act's characterization of the interests it creates as "accounts" rather than as annuities. Part IV then discusses ERISA preemption, focusing upon the tension between *Shaw* and *Travelers*, and next introduces payroll deduction IRA arrangements. In Part VI, this article explains its conclusions as to the three major issues raised by the Act under ERISA and the Code: the notional cash balance-style accounts created by the Act do not qualify as individual retirement accounts since the accounts established by the Act create a defined benefit-type, formula-based claim against a collectively-managed fund. Individual retirement accounts instead allocate investment gain and loss directly to the individual account holder. If the Act were amended to recast its accounts as individual retirement accounts, the Act's employer withholding mandate and the Act's authorization of voluntary employer contributions should survive ERISA preemption under *Travelers*.

Legality, of course, is not the same as wisdom. Thus, the final section addresses the choices other state legislatures, as well as Congress, confront if they elect to follow part or the entire path on which California has embarked to encourage private retirement savings. Among these choices are an employer mandate without a state-sponsored savings vehicle like the California Trust, the augmentation of the federal tax credits for retirement plans and retirement savings with supplementary state tax credits, and the promotion of retirement savings through public education. Other legislatures may reasonably conclude that there is no role for the

states to play in light of both the robust market for retirement savings products and the federal government's support for such savings.

President Obama has recently proposed a federal mandate under which employers with more than ten employees would be required to maintain either retirement plans or IRA coverage.<sup>12</sup> However, the Obama proposal would not create the kind of public investment vehicle established under the California Act. The President's proposal ensures public debate about the appropriate function of government in encouraging retirement savings. The Golden State's Act will play an important role in that debate. In that debate, I favor state-by-state experimentation rather than any single approach to the task of encouraging greater retirement savings.

## II. THE ACT, THE TRUST AND THE PROGRAM DESCRIBED

The Act<sup>13</sup> creates a nine-member board<sup>14</sup> ("the board") to administer the California Secure Choice Retirement Savings Trust<sup>15</sup> ("the Trust"). The Trust will "offer . . . a retirement savings program" to be known as the California Secure Choice Retirement Savings Program<sup>16</sup> ("the program"). Integral to the program is an employer mandate, requiring California employers to maintain for their employees a "payroll deposit retirement savings arrangement."<sup>17</sup> Under these mandated arrangements, employees in the Golden State otherwise without employment-based retirement savings options will be able to contribute to

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<sup>12</sup> See DEP'T OF THE TREASURY, *supra* note 5, at 125.

<sup>13</sup> S.B. 1234 (Cal. 2012).

<sup>14</sup> *Id.* at § 3 (adding § 100002 to the CAL. GOV'T CODE (2012)). In its original incarnation, the Act established a seven member board consisting of the Treasurer of California, California's Director of Finance "or his or her designee," the Controller of California, "[a]n individual with retirement savings and investment expertise appointed by the Senate Committee on Rules," two gubernatorial appointees (one "[a] small business representative," the other "[a] public member") and "[a]n employee representative appointed by the Speaker of the Assembly." *Id.* Senate Bill 923 then amended the Act to add two additional members to the board appointed by the Governor with no restrictions. See S.B. 923, 2012 Leg., Reg. Sess. § 1 (Cal. 2012) (adding § 100002(a)(1)(H) to the CAL. GOV'T CODE (2013)).

<sup>15</sup> S.B. 1234 § 3 (Cal. 2012) (adding § 100004(a) to the CAL. GOV'T CODE (2013)).

<sup>16</sup> *Id.* (adding § 100000(b) to the CAL. GOV'T CODE (2012)).

<sup>17</sup> *Id.* (adding §§ 100000(g) and 100032(d) to the CAL. GOV'T CODE (2012)).

accounts managed by the Trust through employer withholding from employees' paychecks.<sup>18</sup>

Within nine months "after the board opens the program for enrollment,"<sup>19</sup> private and nonprofit employers<sup>20</sup> in the Golden State must have such a payroll "arrangement to allow employee participation in the program"<sup>21</sup> through payroll deductions unless one of several statutory exemptions applies. Under one of these exemptions, an employer need not maintain a state-sponsored payroll deduction arrangement if the employer has fewer than five employees.<sup>22</sup> Moreover, employees cannot participate in the California program if they are covered by the Railway Labor Act<sup>23</sup> or by a multiemployer pension plan.<sup>24</sup> In addition, a California employer need not enroll employees in the state-run program established by the Act if the employer sponsors its own retirement program for its employees<sup>25</sup> or if the employer has in place an IRA payroll deduction plan for its employees.<sup>26</sup>

Thus, when it takes effect, the Act will promulgate an employer retirement savings mandate for California employers. Under the Act's mandate, Golden State employers with five or more employees will be required to have one of three forms of retirement savings arrangements for their employees, i.e., an employer-sponsored plan (including a multiemployer or railroad pension), a payroll IRA deduction plan or, as the default option, a state-sponsored "payroll deposit retirement savings arrangement"<sup>27</sup> under the California program established by the Act.<sup>28</sup>

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<sup>18</sup> *Id.* (adding § 100012(j) to the CAL. GOV'T CODE (2012)).

<sup>19</sup> *Id.* (adding § 100032(d) to the CAL. GOV'T CODE (2012)). During this nine-month period, larger employers must offer payroll deposit retirement savings arrangements. *Id.* (adding §§ 100032(b) and 100032(c) to the CAL. GOV'T CODE (2012)).

<sup>20</sup> *Id.* (adding § 100000(d) to the CAL. GOV'T CODE (2012)). Public employers are specifically exempted from the requirements of the Act. *Id.*

<sup>21</sup> *Id.* (adding § 100032(d) to the CAL. GOV'T CODE (2012)).

<sup>22</sup> *See id.* (adding § 100000(d) to the CL. GOV'T CODE (2012)).

<sup>23</sup> *Id.* (adding § 100000(c)(2)(A-B) to the CAL. GOV'T CODE (2012)).

<sup>24</sup> *Id.* (adding § 100000(c)(2)(B) to the CAL. GOV'T CODE (2012)).

<sup>25</sup> *Id.* (adding §§ 100032(d) and 100032(f) to the CAL. GOV'T CODE (2012)).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* (adding § 100000(f) to the CAL. GOV'T CODE (2012)).

<sup>28</sup> Employers employing four or fewer employees can participate in the program, though they are not required to do so. *Id.* (adding § 100032(a) to the CAL. GOV'T CODE (2012) ("[A]ny employer may choose to have a payroll deposit

When a California employer maintains a payroll savings deposit arrangement pursuant to the state-sponsored program, any of the employer's employees will be able to affirmatively elect against participation in such arrangement.<sup>29</sup> Absent such an election of nonparticipation, each California employee covered by the state-run program will "contribute 3 percent of the employee's annual salary or wages to the program"<sup>30</sup> through employer withholding. However, the Act provides that an employee may specify a contribution rate other than 3%.<sup>31</sup> The Act also provides that the board "may adjust the contribution" rate under the program to as little as 2% of an employee's compensation and as much as 4% of an employee's compensation<sup>32</sup> and may "vary" the program's contribution rate between 2% and 4% "according to the length of time the employee has contributed to the program."<sup>33</sup>

Employee contributions pursuant to the program will be withheld by employers and remitted to the Trust.<sup>34</sup> The Act also permits employers to make supplementary contributions from their own funds to employees' accounts under the program as long as such employer contributions "would not cause the program to be treated as an employee benefit plan under" ERISA.<sup>35</sup>

The Trust will provide a public vehicle for the investment of employees' retirement savings. The Trust and the program, governed by a public board,<sup>36</sup> will collect and provide for the investment of those

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retirement savings arrangement to allow employee participation in the program.")).

<sup>29</sup> *Id.* (adding §§ 100032(e)(1) and 100032(g) to the CAL. GOV'T CODE (2012)).

<sup>30</sup> *Id.* (adding § 100032(h) to the CAL. GOV'T CODE (2012)).

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* (adding § 100032(i) to the CAL. GOV'T CODE (2012)).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* (adding §§ 100000(g) and 100012(j) to the CAL. GOV'T CODE (2012)).

<sup>35</sup> *Id.* (adding §§ 100004(e) and 100012(k) to the CAL. GOV'T CODE (2012)).

Employer contributions cause the California program to become an employee benefit plan for ERISA purposes since such employer contributions transform a payroll deposit IRA arrangement limited to employees' contributions into an employee benefit plan with employer contributions. However, such employer contributions do not trigger preemption under ERISA § 514(a) as explicated by *Travelers*. See *infra* notes 104-24 and accompanying text

<sup>36</sup> *Id.* (adding § 100002 to the CAL. GOV'T CODE (2012), as subsequently amended by S.B. 923, 2012 Leg., Reg. Sess. § 1 (Cal. 2012)).



savings.<sup>37</sup> The monies held in the Trust may, at the board's election, be invested by the treasurer of California.<sup>38</sup> Alternatively, the board can arrange for the Trust's funds to be invested by the board of the California state pension plan<sup>39</sup> (commonly known as CalPERS)<sup>40</sup> or by "private money managers,"<sup>41</sup> or by some combination of CalPERS and private managers.<sup>42</sup> Among the board's other powers in its "capacity of trustee"<sup>43</sup> of the Trust, the board can "[p]rocur[e] insurance against any loss in connection with the property, assets, or activities of the trust, and secure private underwriting and reinsurance to manage risk and insure the retirement savings rate of return."<sup>44</sup>

If the board does not purchase such insurance to protect against losses, the board must instead provide an "annuity, or other funding mechanism . . . at all times that protects the value of individuals' accounts."<sup>45</sup>

Withholding by participating employers under the program is intended to qualify as "payroll deposit IRA arrangements."<sup>46</sup> Each employee contributing to the Trust through employer withholding will have a notional account in the Trust.<sup>47</sup> These notional accounts are intended to qualify as individual retirement accounts under Code § 408.<sup>48</sup> The Act specifically prohibits the board from implementing "the program if the IRA arrangements" offered under the program "fail to qualify for the favorable federal income tax treatment ordinarily accorded to IRAs under the Internal Revenue Code . . . ."<sup>49</sup> This favorable treatment includes the

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<sup>37</sup> According to the Act, the Trust is intended to be financially self-sustaining, paying its administrative costs from the assets contributed to the Trust. *See id.* (adding §§ 100004(c) and 100042 to the CAL. GOV'T CODE (2012)).

<sup>38</sup> *Id.* (adding § 100004(c) to the CAL. GOV'T CODE (2012)).

<sup>39</sup> *Id.*

<sup>40</sup> *See* CALPERS, [www.calpers.ca.gov](http://www.calpers.ca.gov) (last visited Jan. 25, 2014).

<sup>41</sup> S.B. 1234 § 3 (Cal. 2012) (adding § 100004(c) to the CAL. GOV'T CODE (2012)).

<sup>42</sup> *Id.*

<sup>43</sup> *Id.* (adding § 100010(a) introductory language to the CAL. GOV'T CODE (2012)).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.* (adding § 1000013 to the CAL. GOV'T CODE (2012)).

<sup>46</sup> *Id.* (adding § 100008(a) to the CAL. GOV'T CODE (2012)).

<sup>47</sup> *Id.* (adding § 100008(b) to the CAL. GOV'T CODE (2012)).

<sup>48</sup> *Id.* (adding § 100043 to the CAL. GOV'T CODE (2012)).

<sup>49</sup> *Id.* An interesting issue that need not be addressed today is whether the Trust

tax-free growth of investments held within individual retirement accounts,<sup>50</sup> the deductibility of contributions to traditional individual retirement accounts,<sup>51</sup> and the exclusion from income taxation of qualified distributions from Roth individual retirement accounts.<sup>52</sup>

Each employee's account under the program is notional in nature.<sup>53</sup> Each such account will be credited with the employee's contributions<sup>54</sup> through the employer's payroll withholding as well as with the "[S]tated interest rate"<sup>55</sup> selected annually and prospectively by the board and with the Trust's "excess earnings"<sup>56</sup> which the board may, but not need, allocate to employees' accounts. During each year, the board is "to declare the stated rate at which interest shall be allocated to program accounts for the following program year."<sup>57</sup>

There is no provision in the Act for allocating investment losses to employees' accounts or otherwise adjusting such accounts downward to reflect such losses. The employee's "retirement savings benefit under the program"<sup>58</sup> will be a claim against the Trust in "an amount equal to the balance in the [employee's] program account."<sup>59</sup>

As I discuss *infra*,<sup>60</sup> since the Trust's investment gains will not directly pass through to the notional accounts created under the Act, those accounts will not qualify as individual retirement accounts under the Code. The Trust, when it sets "the stated interest rate," can pass through some, all, or none of the Trust's prior investment earnings. Similarly, the board can retroactively credit accounts with some, all or none of the Trust's "excess" earnings above the stated rate of return. The board has no

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would be tax exempt under I.R.C. § 115 (2006) as a governmental agency if the accounts established by the Act do not qualify as IRAs. Since the Act will not go into effect unless the accounts created by the Act are IRAs, this issue need not be confronted, at least for now.

<sup>50</sup> I.R.C. § 408(e)(1) (2011).

<sup>51</sup> I.R.C. § 219 (2011).

<sup>52</sup> I.R.C. § 408A(d)(1) (2011).

<sup>53</sup> S.B. 1234 § 3 (Cal. 2012) (adding § 100008(c) to the CAL. GOV'T CODE (2012)).

<sup>54</sup> *Id.* (adding § 100008(a) to the CAL. GOV'T CODE (2012)).

<sup>55</sup> *Id.* (adding §§ 100000(h) and 100008(b) to the CAL. GOV'T CODE (2012)).

<sup>56</sup> *Id.* (adding § 100006(a-c) to the CAL. GOV'T CODE (2012)).

<sup>57</sup> *Id.* (adding § 100008(b) to the CAL. GOV'T CODE (2012)).

<sup>58</sup> *Id.* (adding § 100008(c) to the CAL. GOV'T CODE (2012)).

<sup>59</sup> *Id.*

<sup>60</sup> *See infra* notes 134-35.

authority to reduce account balances to reflect the Trust's investment losses. These features of the accounts created under the Act preclude those accounts from constituting individual retirement accounts under the Code since the Trust's investment gains and losses do not pass directly to accounts, but are instead mediated through the decisions of the board and through the formulas the board determines.

The Act provides that the State of California has no "liability in connection with funding retirement benefits pursuant to" the program.<sup>61</sup>

The board is not to implement the program if employees' accounts under the program "fail to qualify" as IRAs under the Internal Revenue Code<sup>62</sup> or "if it is determined that the program is an employee benefit plan under" ERISA.<sup>63</sup> Moreover, under S.B. 923, the provisions of the Act will go into effect only if another vote of the California legislature approves the program and the Trust.<sup>64</sup>

### III. FIVE NOTEWORTHY FEATURES OF THE ACT, THE TRUST AND THE PROGRAM

Five features of the Act, the Trust and the program are noteworthy. First, the Act links its employer mandate to withhold and remit employees' retirement contributions to the state-created (but not state-guaranteed) Trust holding and investing such contributions. However, an employer mandate need not be adopted together with a public investment vehicle like the Trust.

A state legislature determined to mandate employee retirement saving could instead require all employers to maintain a qualified plan or an IRA payroll deduction arrangement without establishing the kind of

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<sup>61</sup> S.B. 1234 § 3 (Cal. 2012) (adding §§ 100013, 100014(c)(3), and 100036 to the CAL. GOV'T CODE (2012)).

<sup>62</sup> *Id.* (adding §§ 100043 and 100010(a)(11) to the CAL. GOV'T CODE (2012), authorizing the board "in the capacity of trustee" to "[s]et minimum and maximum investment levels in accordance with contribution limits set for IRAs by the Internal Revenue Code."). Presumably, the individual employee will be given the choice between conventional IRA tax treatment under I.R.C. § 408 or Roth IRA treatment under I.R.C. § 408A – if the Act's accounts are modified to qualify as individual retirement accounts.

<sup>63</sup> *Id.*

<sup>64</sup> S.B. 923, 2012 Leg. Reg. Sess. at § 2 (Cal. 2012) (adding § 100043.5 to the CAL. GOV'T CODE (2012)).

state-sponsored accounts to be managed by the California Trust. This is the approach embodied in President Obama's proposal to establish a national employer mandate requiring retirement savings opportunities in the workplace without establishing any public investment vehicle for such savings.<sup>65</sup>

One could also envision a legislature creating a voluntary state-sponsored investment trust for retirement savings (like current section 529 college savings programs)<sup>66</sup> without the legislature simultaneously enacting an employer mandate requiring workplace savings arrangements. However, the California Act links its employer mandate to a public investment vehicle by sending to the Trust all employee contributions withheld by employers pursuant to the program established under the Act.

A second notable feature of the California Act is the Act's attempt to qualify employees' accounts under the Act as individual retirement accounts. Individual retirement accounts are today ubiquitous instruments for holding employees' retirement wealth.<sup>67</sup> However, as I discuss *infra*,<sup>68</sup> employees' accounts under the California program are not individual retirement accounts, defined contribution devices under which account owners benefit directly from the gains earned by those assets while bearing the losses incurred by those assets. Instead, the employees' interests in their notional accounts in the California Trust resemble participants' entitlements under cash balance pension plans. Cash balance plans are defined benefit arrangements. An employee covered by a cash balance pension has a notional account to which is credited contributions and an assumed rate of interest.<sup>69</sup>

On retirement, the cash balance participant is entitled to receive the balance in his notional account, rather than an amount which reflects

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<sup>65</sup> See *supra* note 5.

<sup>66</sup> See EDWARD A. ZELINSKY, THE ORIGINS OF THE OWNERSHIP SOCIETY: HOW THE DEFINED CONTRIBUTION PARADIGM CHANGED AMERICA 64-70 (2007) (discussing Section 529 plans).

<sup>67</sup> See *id.* at 39-42 (discussing IRAs).

<sup>68</sup> See *infra* notes 134-35.

<sup>69</sup> See generally Edward A. Zelinsky, Cooper v. IBM Personal Pension Plan: A Critique, in NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION 1-1—1-19 (Alvin D. Lurie ed., 2007); Alvin D. Lurie, *Murphy's Law Strikes Again: Twilight For Cash Balance Design?*, 101 TAX NOTES 393 (Oct. 20, 2003); Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683 (2000).

the value of the underlying assets held by the plan. If the employees' cash balance accounts aggregate to more than the assets in the plan, the sponsoring employer is obligated to fund this difference. Conversely, if the assets held by a cash balance pension exceed the total of the employees' notional accounts, those extra assets may revert to the employer.<sup>70</sup> Thus, as a defined benefit plan, a cash balance pension assigns the benefits and downsides of investment performance to the sponsoring employer.

The accounts created by the Act resemble this kind of cash balance arrangement rather than an individual retirement account under which investment risk is, for better or worse, assigned to the account holder. The Act does not authorize the allocation of investment losses to the accounts authorized by the Act. Under the Act, there is no direct connection between the Trust's investment gains and the balances of such accounts. Rather, the Trust's investment gains will be mediated through the board's selection of a stated rate of return for employees' accounts and by the board's decisions to allocate (or not) some or all of the Trust's "excess" investment gains above the stated rate of return. That stated return, to be picked before the year begins, may prove higher, the same or lower than the Trust's actual investment performance. As I discuss *infra*,<sup>71</sup> because the cash balance-style accounts established under the Act do not assign investment risk to the employee/account holders, such accounts do not qualify as individual retirement accounts under the Code.

Third, the Act repeatedly and specifically characterizes participants' interests under the programs as "accounts" rather than as annuities.<sup>72</sup> The Act does not subject the Trust to California's regulation of insurance companies<sup>73</sup> or purport to characterize the Trust as an insurance company. Thus, as I discuss further *infra*,<sup>74</sup> the notional accounts established by the Act not only fail to qualify as individual retirement accounts under the Code, but they also are not individual retirement annuities for purposes of Code § 408(b).<sup>75</sup>

A fourth notable feature of the Golden State's program is its

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<sup>70</sup> Such a reversion is subject to an excise tax. 26 I.R.C. § 4980(a) (2010).

<sup>71</sup> See *supra* text accompanying notes 68-69.

<sup>72</sup> See *generally* S.B. 1234, 2012 Leg., Reg. Sess. (Cal. 2012) (adding § 100008(b) to the CAL. GOV'T CODE).

<sup>73</sup> See *generally* CAL. INS. CODE.

<sup>74</sup> See discussion *infra* 166-176 and accompanying text.

<sup>75</sup> See 26 U.S.C. § 408(b) (2006).

automatic enrollment of eligible employees, subject to each employee's ability to opt out of the program if the employee so chooses. The program's automatic enrollment feature reflects the influential observations of behavioral economists that individuals are often subject to inertia and procrastination in making important decisions like the decision to save for retirement.<sup>76</sup> From the premise of inertia and procrastination, many commentators conclude that higher participation rates can be achieved in 401(k) and similar retirement savings arrangements if employees are presumptively included in such arrangements and required to elect out, rather than being obligated to affirmatively elect coverage under such arrangements.<sup>77</sup> Just as procrastination and inertia discourage employees from electing to save for retirement, procrastination and inertia discourage employees from electing against such saving when saving is presumptive and must be affirmatively rejected.

This insight of behavioral economics led Congress to amend Code § 401(k) to authorize sponsoring employers to adopt automatic enrollment provisions.<sup>78</sup> Under these provisions, employees contribute from their salaries to their retirement accounts unless such employees choose not to contribute. Initial “[s]tudies have shown that automatically enrolling people into 401(k) plans can achieve higher levels of participation.”<sup>79</sup> In this spirit, the Patient Protection and Affordable Care Act mandates that large employers must automatically enroll their covered employees into employer-sponsored health plans, subject to the employees' ability to opt out.<sup>80</sup> The California Act and the program the Act creates embrace this

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<sup>76</sup> Hanming Fang and Dan Silverman, *Distinguishing Between Cognitive Biases*, in BEHAVIORAL PUBLIC FINANCE 51, 55-56 (Edward J. McCaffery and Joel Slemrod eds., 2006).

<sup>77</sup> See *id.*; WILLIAM J. CONGDON ET AL., POLICY AND CHOICE 77-79 (2011); James J. Choi et al., *Saving for Retirement on the Path of Least Resistance*, in BEHAVIORAL PUBLIC FINANCE, *supra* note 76, at 304; Annie Lowrey, *Tax Breaks and Savings Play Role in Budget Talks*, N.Y. TIMES, Nov. 26, 2012, at A19 (“policies that automatically saved a portion of a worker's income increased total savings by a substantial amount.”).

<sup>78</sup> 26 I.R.C. § 401(k)(13) (2006). See also Fran Hawthorne, *Heading for Retirement on Autopilot*, N.Y. TIMES, Feb. 11, 2013.

<sup>79</sup> Jonathan Barry Forman & Gordon D. Mackenzie, *Optimal Rules for Defined Contribution Plans: What Can We Learn from the U.S. and Australian Pension Systems* 36 (Austl. Sch. of Bus., Working Paper No. 2013), available at <http://ssrn.com/abstract=1954879>.

<sup>80</sup> Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1511,

increasingly fashionable pattern of automatic enrollment under which eligible employees presumptively contribute to their respective program accounts unless they affirmatively reject such contributions.<sup>81</sup>

A fifth notable feature of the Act is the acknowledgment of the problem of implicit government guarantees and the Act's explicit repudiation of any such guarantees. Recent discussion about implicit government guarantees has occurred in the context of banks and other financial institutions deemed "too big to fail," as well as government-sponsored entities such as Fannie Mae and Freddie Mac.<sup>82</sup> Important commentators suggest that these large institutions and entities benefit from an unstated but widely-accepted understanding that the federal government could not permit any of these institutions or entities to become insolvent.<sup>83</sup> From this vantage, there is an implicit guarantee that the federal government will again bail out many of these institutions and entities, as the federal government did during the Great Recession.

The Act explicitly and repeatedly warns that the State of California is not liable to the employees who participate in the program.<sup>84</sup> According to the Act, participating employees must be paid from the assets of the Trust including any private insurance coverage the Trust may purchase to guarantee the program's promises to such employees.<sup>85</sup> While the Act reiterates that the treasury of the Golden State does not stand behind the Trust or the program, some critics suggest that, despite the Act's disclaimer of state liability to the employees who participate in the program, in a crunch, no future governor or legislature of California could in fact stand by idly if the Trust lacked the financial ability to pay the

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124 Stat. 119, 252 (2010) (amending the Fair Labor Standards Act of 1938 by adding § 18A, codified as amended at 29 U.S.C. § 218A (2010)).

<sup>81</sup> President Obama takes a similar approach in his proposal for a federal employer mandate for workplace retirement savings. *See supra* text accompanying notes 4-5.

<sup>82</sup> *See, e.g.,* SHEILA BAIR, *BULL BY THE HORNS* (2012); ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS – AND THEMSELVES* (2009); Gretchen Morgenson, *One Safety Net That Needs to Shrink*, N.Y. TIMES, Nov. 4, 2012, at BU1.

<sup>83</sup> *See, e.g.,* Bair, *supra* note 82, at 28 ("The moral hazard problem is worse for very large institutions that the market perceives as being too big to fail.").

<sup>84</sup> *See* S.B. 1234, 2012 Leg., Reg. Sess. § 3 (Cal. 2012) (adding §§ 100013, 100014(c)(3) and 100036 to the CAL. GOV'T CODE (2012)).

<sup>85</sup> *Id.* (adding § 100010(a)(9) to the CAL. GOV'T CODE (2012)).

account balances of such employees.<sup>86</sup> In discussion of S.B. 1234, the California Department of Finance expressed this concern that California's treasury might ultimately wind up responsible for the program's commitments.<sup>87</sup> However, the text of the Act is explicit that the Golden State's public treasury does not stand behind the Trust.

#### IV. ERISA PREEMPTION: *Shaw v. Travelers*

ERISA's preemption clause, ERISA § 514(a),<sup>88</sup> is extremely broad: ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan" regulated by ERISA. Starting with its decision in *Shaw v. Delta Air Lines, Inc.*<sup>89</sup> through *District of Columbia v. Greater Washington Board of Trade*,<sup>90</sup> the U.S. Supreme Court interpreted § 514(a) expansively.<sup>91</sup> Under the case law developed during this period, § 514(a) preempts any state law which "has a connection with or reference to" an employee benefit plan.<sup>92</sup> Under this

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<sup>86</sup> See, e.g., Frank Keegan, *Private Pension Plan Would Raid Taxpayers to Fill Public Pension Gap*, SACRAMENTO BEE, Sept. 29, 2012, at A13 ("But the overriding question left answered on the issue of 'guaranteed' retirement income is: guaranteed by whom? Answer: taxpayers, the same people now stuck with the insurmountable debt of a retirement system in an accelerating death spiral."); Rich Danker, *California Doubles Down on Pension Promising*, CONTRA COSTA TIMES, Nov. 11, 2012, at A13 (The Act "confuses retirement as an expectation, rather than an objective."); Judy Lin, *The Problems with SB1234*, ASSOC. OF CAL. LIFE & HEALTH INS. CO., May 30, 2012 ("Funding shortfalls and huge taxpayer liabilities.").

<sup>87</sup> See Kevin DeLeon, Department of Finance Bill Analysis (May 2, 2012) (on file with the California Department of Finance) ("Despite the bill's stated intent to shield the state from financial liability, the state ultimately could be responsible for benefit payments under federal law, putting the state at serious risk of billions of dollars in unfunded liabilities if investment performance falters under the Program.").

<sup>88</sup> 29 U.S.C. § 1144(a) (2006).

<sup>89</sup> See *Shaw v. Delta Air Lines*, 463 U.S. 85 (1983).

<sup>90</sup> See *D.C. v. Greater Wash. Bd. of Trade*, 506 U.S. 125 (1992).

<sup>91</sup> For a detailed discussion of this initial stage of the Court's interpretation of ERISA § 514(a), see Edward A. Zelinsky, *Travelers, Reasoned Textualism, and the New Jurisprudence of ERISA Preemption*, 21 CARDOZO L. REV. 807, 815-27 (1999).

<sup>92</sup> See *Shaw*, 463 U.S. at 97.



unforgiving standard, ERISA preemption is nearly automatic.<sup>93</sup>

The Court subsequently retreated from *Shaw*'s formulation of ERISA preemption, without (so far, at least) acknowledging that retreat. In *New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co.*,<sup>94</sup> the Court formulated a more restrained (though still quite broad) understanding of ERISA § 514(a), presuming “that Congress does not intend to supplant state law.”<sup>95</sup>

*Travelers* involved surcharges New York State imposed as part of its regulation of hospital rates. Pursuant to this regulation, hospitals charged patients covered by Blue Cross/Blue Shield, by Medicaid, or by an HMO only basic billing rates for their hospital stays. Other patients, e.g., those covered by commercial insurers, by self-insured funds, or by volunteer firefighter benefits, paid to the hospital a 13% surcharge for their hospitalizations. Hospitalized patients covered by commercial insurance also paid a second surcharge of 11%, which the hospital remitted to the state. The impact of these surcharges was to encourage employers to switch their medical plans from commercial insurance and self-funding to Blue Cross/Blue Shield coverage to achieve lower net costs for their employees' hospitalizations.

In a straightforward application of *Shaw* and its expansive test for ERISA preemption (“connection with or reference to”), the Second Circuit<sup>96</sup> held that ERISA § 514(a) preempted New York's hospital surcharges. These surcharges, the appeals court concluded, improperly burdened employers' ERISA-regulated health care plans with higher costs if such plans declined to use Blue Cross/Blue Shield insurance coverage.

In a sharp (but, so far, unacknowledged) break with *Shaw*, the Supreme Court reversed the Second Circuit and upheld the Empire State's hospital surcharges against ERISA preemption challenge. The interpretation of § 514(a) in any situation, *Travelers* declares, starts with the “presumption that Congress does not intend to supplant state law.”<sup>97</sup> Through § 514(a), Congress sought “to avoid a multiplicity of [state] regulation in order to permit the nationally uniform administration of employee benefit plans.”<sup>98</sup> The danger to such national uniformity is

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<sup>93</sup> See Zelinsky, *supra* note 91, at 816.

<sup>94</sup> 514 U.S. 645 (1995) [hereinafter *Travelers*].

<sup>95</sup> See *id.* at 654.

<sup>96</sup> *Travelers Ins. Co. v. Cuomo*, 14 F.3d 708, 725 (2d Cir. 1993).

<sup>97</sup> *Travelers*, 514 U.S. at 654.

<sup>98</sup> *Id.* at 657.

greatest when a state law dictates “employee benefit structures or their administration”<sup>99</sup> or provides “alternative enforcement mechanisms.”<sup>100</sup> A state law is not ERISA-preempted under § 514(a) merely because of its “indirect economic influence” on employee benefit plans.<sup>101</sup>

It is hard to reconcile *Travelers*’ more forgiving approach to ERISA preemption with *Shaw*. The Court has, so far, declined to confront the tension in its ERISA preemption case law.<sup>102</sup>

Often, the tension between *Shaw* and *Travelers* does not matter. For example, Maryland’s “Wal-Mart” Act is ERISA-preempted under either approach.<sup>103</sup> However, as I discuss below, the California Act presents a case where the two different formulations of ERISA preemption lead to two different outcomes. ERISA preempts the Act’s employer mandate and the Act’s authorization of voluntary employer contributions under the *Shaw* standard with its near automatic preemption of state law. However, the Act’s employer mandate and optional employer contributions survive under the revised and more compelling approach to ERISA § 514(a) later embodied in *Travelers*.

## V. THE PAYROLL DEDUCTION IRA SAFE HARBOR

ERISA preempts state laws as such laws “relate to any employee benefit plans”<sup>104</sup> governed by ERISA. ERISA identifies two kinds of employee benefit plans,<sup>105</sup> “welfare” plans,<sup>106</sup> which provide fringe benefits such as medical, sickness and death benefit coverage, and “pension” plans,<sup>107</sup> which provide “retirement income to employees”<sup>108</sup> or otherwise result “in a deferral of income by employees for periods

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<sup>99</sup> *Id.* at 658.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 659.

<sup>102</sup> See Zelinsky, *supra* note 93, for a discussion on the tension within the Supreme Court’s ERISA preemption case law.

<sup>103</sup> Edward A. Zelinsky, *Maryland’s “Wal-Mart” Act: Policy and Preemption*, 28 CARDOZO L. REV. 847, 851-70 (2006).

<sup>104</sup> 29 U.S.C. § 1144(a) (2006).

<sup>105</sup> 29 U.S.C. § 1002(3) (2006).

<sup>106</sup> 29 U.S.C. § 1002(1) (2006).

<sup>107</sup> 29 U.S.C. § 1002(2)(A) (2006).

<sup>108</sup> 29 U.S.C. § 1002(2)(A)(i) (2006).

extending to the termination of covered employment or beyond.”<sup>109</sup>

The regulations of the Department of Labor (DOL) create a safe harbor from ERISA regulation for what have come to be called “payroll deduction IRA” arrangements.<sup>110</sup> Per the regulations,<sup>111</sup> a payroll deduction IRA arrangement is not a “pension” plan for ERISA purposes, chiefly because only the employee contributes to his IRA under such an arrangement; there are no employer contributions. Since it is not a pension plan, a payroll deduction device is not an “employee benefit plan” and thus is not regulated by ERISA. Consequently, ERISA § 514(a) does not preempt a state law relating to a payroll deduction IRA arrangement because such a payroll deduction arrangement is not an employee benefit plan for purposes of ERISA. The drafters of the California Act attempted to qualify the Golden State’s program for this safe harbor<sup>112</sup> so that the program will constitute a payroll deduction IRA arrangement, subject to state regulation, rather than an ERISA-regulated pension plan with respect to which state law is preempted.

The DOL regulations define a payroll deduction IRA arrangement, outside ERISA’s coverage, as a “completely voluntary”<sup>113</sup> scheme which is

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<sup>109</sup> 29 U.S.C. § 1002(2)(A)(ii) (2006).

<sup>110</sup> Announcement 99-2, 1991-1 CB 305; *see also* EBSA & IRS, *Payroll Deduction IRAs for Small Businesses*, [www.dol.gov/ebsa/publications/PayrollDedIRAs.pdf](http://www.dol.gov/ebsa/publications/PayrollDedIRAs.pdf).

<sup>111</sup> 29 C.F.R. § 2510.3-2(d) (2013).

<sup>112</sup> S.B. 1234, 2012 Leg., Reg. Sess. (Cal. 2012) (adding § 100032 to the CAL. GOV’T CODE (2012), describing the Act as permitting and requiring “payroll deposit retirement savings arrangement[s].”).

<sup>113</sup> 29 C.F.R. § 2510.3-2(d)(ii). Employees’ participation in the withholding program created by the Act would be “completely voluntary” because every employee under the Act would have the option to opt out of the program. S.B. 1234 § 3 (Cal. 2012) (adding §§ 100014(c)(3), 100032(e)(1) and 100032(g) to the CAL. GOV’T CODE (2012)). There is a counterargument that participation in the program would not be “completely voluntary” since the employee would have the burden of opting out. However, this burden does not seem weighty enough to conclude that employees’ participation in the program would be less than voluntary. The Department of Labor (“DOL”) came to a similar conclusion in the context of health savings accounts (“HSAs”). Specifically, DOL’s Employee Benefits Security Administration concluded that “the establishment of an HSA by an employee [is] ‘completely voluntary’” when an employer creates and funds an HSA as long as the employee “may move the funds to another HSA or otherwise withdraw the funds.” Robert J. Doyle, *Health Savings Accounts – ERISA Q&As*, FIELD ASSISTANCE

solely employee-financed. No contributions can come from the employer.<sup>114</sup> Under an IRA payroll arrangement, the “sole involvement of the employer” “is without endorsement to permit the sponsor to publicize the program,” “to collect contributions through payroll deductions,” and to remit such contributions to the employees’ respective IRAs.<sup>115</sup>

Payroll deduction IRA arrangements contrast with two other IRA-based retirement savings devices, the “simplified employee pension” (SEP)<sup>116</sup> and the “simple retirement account (SRA).”<sup>117</sup> For purposes of the present discussion, the principal difference between these IRA-based savings devices and payroll deduction IRAs is that employers make contributions to SEPs and SRAs, but do not make contributions under payroll deduction IRA arrangements. Because the employer contributes to a SEP or a SRA, a SEP or a SRA is (unlike a payroll deduction IRA) an ERISA-regulated employee benefit plan.<sup>118</sup>

Under a SEP, the employer makes contributions to IRAs for its employees in proportion to such employees’ respective compensation.<sup>119</sup> SRAs require employer contributions emulating the safe harbor contributions for 401(k) plans. Specifically, an employer sponsoring SRAs for its employees must either match employees’ salary reduction contributions to their IRAs<sup>120</sup> or must contribute across-the-board to

BULL. NO. 2006-02, Employee Benefits Security Administration, U.S. Dep’t of Labor (Oct. 27, 2006), <http://www.dol.gov/ebsa/pdf/fab2006-2.pdf>. This conclusion is persuasive and confirms that employees’ participation in the withholding program created by the Act would be “completely voluntary” within the meaning of 29 C.F.R. § 2510.3-2(d)(ii).

<sup>114</sup> 29 C.F.R. § 2510.3-2(d)(i).

<sup>115</sup> 29 C.F.R. § 2510.3-2(d)(iii). Moreover, the employer cannot receive “consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions.” 29 C.F.R. § 2510.3-2(d)(iv).

<sup>116</sup> 26 U.S.C. § 408(k) (2006).

<sup>117</sup> 26 U.S.C. § 408(p) (2006).

<sup>118</sup> 29 U.S.C. § 1002(2)(A) (2006).

<sup>119</sup> 26 U.S.C. § 408(k)(3) (2006). Before 1997, employers could establish so-called “SAR-SEPs,” simplified employee pensions with salary reduction arrangements under which employees can also contribute to their respective IRAs subject to 401(k)-type deferral testing. While existing SAR-SEPs were grandfathered, new SAR-SEPs can no longer be created. 26 U.S.C. § 408(k)(6)(H) (2006).

<sup>120</sup> See *infra* notes 204-210 and accompanying text.

employees' IRAs at a rate of 2% of each employee's compensation.<sup>121</sup>

As I discuss *infra*,<sup>122</sup> if a California employer were to make employer contributions under the provisions of the Act authorizing such optional employer contributions, these voluntary employer contributions would convert the California program for this employer from a payroll deduction IRA arrangement,<sup>123</sup> limited to employee contributions, into an ERISA-regulated employee pension plan, namely, either a SEP or a SRA financed by employer contributions. As I also discuss below,<sup>124</sup> under *Shaw*, ERISA § 514(a) preempts the provisions of the Act authorizing employer contributions though those provisions are not preempted under *Travelers*.

## VI. THE ACT'S NOTIONAL ACCOUNTS ARE NOT INDIVIDUAL RETIREMENT ACCOUNTS

### A. APPLYING THE STATUTORY LANGUAGE OF ERISA AND THE CODE

A fundamental question is whether the accounts established under the Act are individual retirement accounts for purposes of the Code. The drafters of the Act labeled these as "accounts" and intended for these self-proclaimed accounts to qualify as individual retirement accounts.<sup>125</sup> The Act prohibits the board from implementing "the program if the IRA arrangements" offered under the program "fail to qualify for the favorable federal income tax treatment ordinarily accorded to IRAs under the Internal Revenue Code . . . ."<sup>126</sup>

The cash balance-style notional accounts established by the Act do not qualify as individual retirement accounts under the Code as the Act's accounts do not benefit directly from investment gains nor do such

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<sup>121</sup> 26 U.S.C. § 408(p)(2)(B)(i) (2006). The 2% employer contributions under simple retirement accounts are similar to the 3% employer contributions under one type of 401(k) safe harbor arrangement. 26 U.S.C. § 401(k)(12)(C) (2006).

<sup>122</sup> See *infra* notes 203-09 and accompanying text.

<sup>123</sup> This assumes that the Act will be amended to convert its cash balance-style "nominal" accounts into true IRAs that allocate investment risk to the account holder.

<sup>124</sup> See *infra* notes 211-219 and accompanying text.

<sup>125</sup> S.B. 1234, 2012 Leg., Reg. Sess. (Cal. 2012) (adding § 100043 to the CAL. GOV'T CODE (2012)).

<sup>126</sup> *Id.*

accounts bear investment losses. The accounts created by the Act are notional accounts that give the employee a formula-based defined benefit-type claim against the assets held collectively by the Trust. That claim is not based on the value of those Trust assets. California's program is not a defined contribution arrangement with individual accounts assigning investment risk and reward to the account holder. Accounts under the Act will be credited with an assumed rate of return determined before the commencement of the year.<sup>127</sup> For any year, the Trust's actual investment performance may prove to be higher, the same as, or lower than the rate assumed before the year began. The board can retroactively allot to the program accounts some, all, or none of the Trust's "excess" investment gains above the stated rate of return. In any event, accounts under the Act will not be decreased to reflect the Trust's investment losses. Consequently, the cash balance-style notional accounts that the Act authorizes are not individual retirement accounts.

Internal Revenue Code § 408, which establishes the "individual retirement account" as a matter of federal law, does not define that statutory term. However, as part of ERISA (which created the IRA),<sup>128</sup> Congress twice<sup>129</sup> adopted a statutory definition to distinguish defined contribution arrangements, such as money purchase pensions<sup>130</sup> and profit sharing plans,<sup>131</sup> from defined benefit pensions. The ERISA (i.e., Title 29) version of this definition makes clear that the term "individual account plan" is synonymous with "defined contribution plan" and provides that,

[t]he term "individual account plan" or "defined contribution plan" means a pension plan which provides for an individual account for each participant and for

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<sup>127</sup> *Id.* (adding § 100008(b) to the CAL. GOV'T CODE (2012)).

<sup>128</sup> See An Act to Provide Pension Reform, Pub. L. No. 93-406, § 2002(b), 88 Stat. 829, 959-66 (1974) (adding § 408 to the *United States Code*, creating the individual retirement account).

<sup>129</sup> As observed *supra*, many provisions of ERISA were adopted twice, once as additions to the Internal Revenue Code and once as additions to Title 29 of the *United States Code*, enforced by the Department of Labor. See *supra* note 6.

<sup>130</sup> On money purchase pension plans, see ZELINSKY, *supra* note 66, at 2; LANGBEIN ET AL., *supra* note 6, at 50-51; LAWRENCE A. FROLIK & KATHRYN L. MOORE, LAW OF EMPLOYEE PENSION AND WELFARE BENEFITS 33 (3d ed. 2012).

<sup>131</sup> On profit sharing plans, see ZELINSKY, *supra* note 66, at 2, 4, 14; LANGBEIN ET AL., *supra* note 6, at 51-52; FROLIK & MOORE, *supra* note 130, at 33-34.

benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.<sup>132</sup>

The Internal Revenue Code version of this definition, today part of the tax statute as 26 U.S.C. § 414(i),<sup>133</sup> is identical except that the tax law exclusively uses the term "defined contribution plan."

Under this twice-enacted definition, an account exists for retirement savings purposes only when a participant's interest in his own account is "based solely upon the amount contributed to the participant's account, and any income, expenses, gain and losses, and any forfeitures of accounts . . . which may be allocated to such participant's account."<sup>134</sup> An individual account does not exist for retirement savings purposes if an external formula, operating independently of actual earnings and losses, determines a participant's entitlement under the retirement plan. Thus, a retirement account (in contrast to a defined benefit arrangement) exists only when investment risk is placed directly on the account holder so that all investment gain automatically inures to the advantage of the account holder and investment losses decrease the account holder's entitlement under the plan.

In contrast, the Act's notional, cash balance-style accounts do not reflect the Trust's actual investment experience but instead implement a defined benefit-style formula, namely, contributions augmented by an assumed rate of return unreduced by any losses. Under the California Act, the account holder is entitled to this formula-established amount, regardless of the Trust's actual investment performance. The account holder's interest does not derive directly from the value of the assets held by the Trust. Rather, the account holder has a defined benefit-style, formula-based claim against the collective fund held by the Trust. This formula ignores losses and automatically credits each account with an assumed rate of return, regardless of the Trust's actual investment performance. Hence, the accounts to be created under the Act do not comply with the statutory mandate that IRAs must provide "benefits based solely upon the amount contributed to the participant's account, and any

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<sup>132</sup> 29 U.S.C. § 1002(34) (2006).

<sup>133</sup> 26 U.S.C. § 414(i) (2006).

<sup>134</sup> 29 U.S.C. § 1002(34) (2006).

income, expenses, gains and losses, and any forfeitures . . . .”<sup>135</sup>

Suppose, for example, a year for which the California board assumes a return of 3% while the Trust established by the Act actually experiences a net investment gain of 5%. The board could retroactively allocate this “excess” investment gain to the program’s accounts or could consider this superior investment performance in setting the stated return for the following year. The board may also do both or neither. Under any of these scenarios, there will be no direct connection between the Trust’s investment performance and the accounts’ balances. Any investment gain is mediated through the board and its implementation of the statutory command to assume a rate of return before the beginning of each year.

Suppose, moreover, a year in which the Trust losses money on the investments it holds. The Act does not authorize a decrease in account balances to reflect these losses. Following a loss year, the board might assume a 0% return so that account balances stay the same in the face of the prior year’s investment losses. However, the statutory definition of an individual account requires that losses reduce account balances.<sup>136</sup> As the Act is written, there is no provision for such loss-based reductions to account balances under the California program.

In short, as a statutory matter, all retirement accounts, including individual retirement accounts, must directly reflect investment gains and losses. The formula-based, cash balance-style accounts fashioned by the California Act do not and thus cannot constitute individual retirement accounts under Internal Revenue Code § 408.

#### B. APPLYING THE CASE LAW ON RETIREMENT ACCOUNTS

Also instructive in this context is the seminal decision of the U.S. Court of Appeals for the Ninth Circuit in *Connolly v. Pension Benefit Guaranty Corp.*<sup>137</sup> *Connolly*, and its progeny,<sup>138</sup> confirm that the defined

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<sup>135</sup> *Id.*; I.R.C. § 414(i) (2006).

<sup>136</sup> *Id.*

<sup>137</sup> *Connolly v. Pension Benefit Guar. Corp.*, 581 F.2d 729 (9th Cir. 1978).

<sup>138</sup> *Connolly* has been cited and followed in three subsequent decisions addressing the distinction between defined benefit pensions and defined contribution/individual account plans: *Concord Control, Inc. v. Int’l Union, United Auto., Aerospace and Agric. Implement Workers of Am.*, 647 F.2d 701, 704-05 (6th Cir. 1981); *Matter of Defoe Shipbuilding Co.*, 639 F.2d 311, 313 (6th Cir. 1981); *In re Gray-Grimes Tool Co., Inc. Pension Plan*, 546 F. Supp. 102, 107-09



benefit-style accounts established by the Act are not individual retirement accounts for purposes of the Code.

The question before the court in *Connolly* was whether a multiemployer<sup>139</sup> pension plan was a defined benefit plan, subject to the plan termination insurance administered by the Pension Benefit Guaranty Corporation (“PBGC”), or was a defined contribution/individual account plan, outside the coverage of the PBGC and its insurance program.<sup>140</sup> Starting with ERISA’s statutory definition of a defined contribution/individual account plan,<sup>141</sup> the appeals court concluded that the plan at issue in *Connolly* was a defined benefit pension because benefits were based on a formula rather than the actual investment experience of any particular individual account.

The appeals court noted that, under the *Connolly* plan, “[c]ontributions on behalf of participants are pooled in a general fund . . . [T]he participant has no right, title, or interest in these [contributed] amounts.”<sup>142</sup> Rather, the participant’s entitlement under the plan was based on a specified formula. Such a formula is a feature of a defined benefit plan, which, as its name implies, defines for each participant a retirement benefit by applying a formula established in the plan. This formula applies irrespective of the plan’s actual investment performance.

In *Connolly*, the plan’s formula utilized the participant’s years of service to determine the participant’s retirement benefit. Under the California program, a cash balance-type formula creates a notional account consisting of cumulative contributions adjusted by an assumed rate of return, unreduced by any losses. The board can, but need not, retroactively credit accounts with some or all of the Trust’s “excess” investment earnings. As is true of the cash balance accounts that the Act’s accounts emulate, actual investment performance will not directly increase the participants’ benefits in their accounts in the California program, nor will investment losses decrease such benefits.

Also instructive in this context is the supplementary test deployed by the *Connolly* court, the possibility of underfunding. “[B]y definition, an

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(E.D. Mich. 1982).

<sup>139</sup> For discussion of multiemployer pension plans, see LANGBEIN ET AL., *supra* note 6, at 70-77.

<sup>140</sup> 29 U.S.C. § 1321(b)(1) (2006) (PBGC insurance does not apply to “an individual account plan”).

<sup>141</sup> 29 U.S.C. § 1002(34) (2006).

<sup>142</sup> *Connolly*, 581 F.2d at 733.

individual account plan can never be underfunded”<sup>143</sup> since the account holder is entitled to whatever total his account grows or falls, based on the account’s actual investment performance. In contrast, there can be underfunding with cash balance notional accounts since these are defined benefit devices; if plan assets are less than a cash balance participant’s notional account total, the participant is still entitled to this larger formula-based total. Conversely, if a cash balance plan has more assets than are necessary to pay every participant the amount in his notional account, that excess can revert to the employer.<sup>144</sup>

Like the plan at issue in *Connolly*, the California program creates a defined benefit-type cash balance entitlement that may be underfunded (or overfunded). Whether assets in the Trust are more or less than the amount in participants’ notional accounts, the California participants are entitled to their respective formula-based entitlements as reflected in those notional accounts.<sup>145</sup> If assets in the Trust are insufficient to pay these amounts, the account holders will have a claim against the Trust’s collective assets for the holders’ respective formula-based benefits. The California account holder under the Act has a defined benefit-type claim against this total pool of Trust assets, a claim for the formula-based total in his notional account.

Significant in this context is the Act’s authorization of the board to purchase insurance to guarantee against underfunding.<sup>146</sup> As the Ninth Circuit observed in *Connolly*, individual account plans cannot be underfunded. Insurance against underfunding is the hallmark of a defined benefit pension that promises a benefit-based formula independent of the value of the assets actually financing the pension. Today, defined benefit insurance is administered by the PBGC, established by ERISA.<sup>147</sup> If a defined benefit pension plan is covered by such insurance<sup>148</sup> and if the

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<sup>143</sup> *Id.*

<sup>144</sup> Such a reversion is subject to the excise tax of Code § 4980. I.R.C. § 4980 (2006).

<sup>145</sup> S.B. 1234, 2012 Leg., Reg. Sess. § 3 (Cal. 2011) (adding § 100008(c) to the CAL. GOV’T CODE (2012)).

<sup>146</sup> *Id.* (adding § 100010(a)(9) to the CAL. GOV’T CODE (2012)).

<sup>147</sup> The PBGC and its insurance program are established in ERISA § 4001, 29 U.S.C. § 1301 (2006). For background on the PBGC, see LANGBEIN ET AL., *supra* note 6, at 238-40; FROLIK & MOORE, *supra* note 130, at 626-30.

<sup>148</sup> Certain defined benefit plans are not subject to the PBGC and the insurance it provides. 29 U.S.C. § 1321(b)-(c) (2006).

assets held by the plan's trust are inadequate to pay promised benefits, the PBGC's insurance coverage makes up the difference for basic, insured benefits.<sup>149</sup>

Under California's Act, the board administering the program and Trust is authorized to obtain similar insurance from a private insurer.<sup>150</sup> This authorization indicates the risk of defined benefit underfunding under the Act. Underfunding insurance is not purchased for a defined contribution account since there is no promised benefit to insure and thus no risk of underfunding against which to insure.

In short, under the statutory definition of a retirement account as explicated by *Connolly*, an individual account benefits directly from investment gain, loses value from investment losses, is not controlled by a formula separate from such gains and losses, and cannot be underfunded since the account holder is entitled to whatever his account balance may be. Hence, the notional accounts under the Act are not individual retirement accounts. Rather, the accounts created under the Act reflect a defined benefit-style formula that gives the account holder a fixed claim against a collectively-invested trust fund. The Trust's investment gains will not automatically pass through to participants' program accounts but rather will be mediated by the board through its choice of an assumed rate of return and its decision whether or not to credit accounts with the Trust's "excess" earnings. Since the Act's accounts can be underfunded (why else should the board buy insurance against the risk of underfunding?), those accounts are not individual retirement accounts.

The same conclusion emerges from the appeals courts' decisions under the Code version of the definition of a defined contribution plan, Code § 414(i).<sup>151</sup> The most recent of these appeals court decisions is *George v. United States*.<sup>152</sup> In *George*, the taxpayers were retirees from federal service who, while working, had participated in the Civil Service Retirement System (CSRS). These taxpayers had contributed to the CSRS from their salaries with after-tax dollars while the federal government, as employer, matched those contributions. When they retired, the *George* taxpayers elected to receive their own after-tax contributions as lump sum distributions while the remainder of their respective CSRS retirement

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<sup>149</sup> 29 U.S.C. §§ 1322-1322a (2006).

<sup>150</sup> S.B. 1234 § 3 (Cal. 2012) (adding § 100010(a)(9) to the CAL. GOV'T CODE (2012)).

<sup>151</sup> I.R.C. § 414(i) (2006).

<sup>152</sup> 90 F.3d 473 (Fed. Cir. 1996).

benefits (attributable to employer contributions and earnings) were paid over time as annuities.

The issue in *George* was whether the lump sum and the annuity constituted a single, integrated contract or whether the lump sum (consisting of the employees' own contributions) was a separate defined contribution pension plan, treated for tax purposes apart from the annuity. Under the former characterization, the lump sum (deemed to be integrated with the annuity) was taxable for income tax purposes. Under the latter characterization, the lump sum (deemed to be a separate defined contribution plan) was a tax-free refund of the taxpayers' own, already taxed contributions.<sup>153</sup> The *George* taxpayers, relying on Code §§ 72(d) and 72(e)(5)(E), claimed that their contributions to the CSRS constituted a separate defined contribution plan. From this premise, the lump sum payments were the tax-free return of their respective after-tax contributions. The IRS, relying on Code § 72(e)(2)(A), asserted that the lump sum payments to the CSRS retirees were linked to the ongoing annuity payments and were thus fully taxable. The resolution of this issue turned on the applicability of Code § 414(i): were the taxpayers' after-tax contributions a separate defined contribution pension plan or were they part of the annuity paid by the CSRS?

The Federal Circuit, agreeing with two other courts of appeals,<sup>154</sup> held that the taxpayers' after-tax contributions did not constitute a separate defined contribution plan with a "separate account"<sup>155</sup> because a defined contribution plan must have an "investment-performance feature,"<sup>156</sup> i.e.,

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<sup>153</sup> "Employee contributions...under a defined contribution plan may be treated as a separate contract." I.R.C. § 72(d) (2006). A lump sum distribution "received on or after the annuity starting date" is fully includable in gross income. I.R.C. § 72(e)(2)(A) (2006). However, I.R.C. § 72(e)(5)(E) provides the counter rule for a lump sum "in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract." I.R.C. § 72(e)(5)(E) (2006). Such a lump sum in the nature of a refund is not taxable, but rather a return of the employees' consideration.

The taxpayers in *George*, relying on Code §§ 72(d)-(e)(5)(E), claimed that their contributions to the CSRS constituted a separate defined contribution plan. Hence, the lump sums they received were in the nature of a tax-free return of the taxpayers' own contributions. 90 F.3d at 477.

<sup>154</sup> *Montgomery v. United States*, 18 F.3d 500 (7th Cir. 1994); *Malbon v. United States*, 43 F.3d 466 (9th Cir. 1994).

<sup>155</sup> I.R.C. § 414(k) (2006).

<sup>156</sup> *George*, 90 F.3d at 477.

investment gains and losses must be allocated to the alleged account holder.

Since the *George* taxpayers were not allocated any investment gains and losses attributable to their after-tax contributions, those taxpayers did not participate in any separate defined contribution pension plan with individual accounts. The lump sum payment from the CSRA did not come from a true individual account that grew from investment gains and incurred investment losses.

Particularly helpful in this context is the *George* Court's discussion of *Guilzon v. Commissioner*,<sup>157</sup> the only appeals court decision holding that the lump sums received by CSRS retirees derive from a defined contribution plan separate from the annuities paid by CSRS to these retirees. Rejecting *Guilzon*, the Federal Circuit correctly observed that, contrary to the conclusion of *Guilzon*, "[u]nder the concept of a defined contribution plan . . . if income is earned, that income is to be added to the participant's account."<sup>158</sup> In contrast, the Act's notional accounts are not true accounts directly absorbing investment risk. Hence, such notional accounts are not individual retirement accounts under Code § 408.

### C. CONSIDERING CRITIQUES

Consider in this context seven potential critiques of my conclusion that the program accounts established by the California Act are not individual retirement accounts for purposes of the Code. First, an individual retirement account can be invested in a fixed income instrument. The individual retirement account so invested resembles the notional accounts established under the Act. Thus, this initial critique would continue, the accounts under the Act are not so different from conventional individual retirement accounts after all.

To explore this challenge, let us suppose that an individual retirement account with a balance of \$100 is invested in a corporate bond that pays interest of 2% annually. At the end of the year, this account predictably has \$102, reflecting the original principal and the first year's interest. Suppose now that an account established under the Act is credited with \$100 in employee contributions and that, for the year, the board

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<sup>157</sup> 985 F.2d 819 (5th Cir. 1993).

<sup>158</sup> *George*, 90 F.3d at 478.

assumes a rate of return of 2%. At the end of the year, this account under the California Act will also have a balance of \$102. This similarity, the argument goes, implies that the Act's accounts are individual retirement accounts for purposes of Code § 408 since the Act's accounts simulate individual retirement accounts invested in fixed income instruments.

As far as it goes, in this example the individual retirement account resembles the notional account under the Act. However, this resemblance evaporates upon further consideration of investment risk and reward. Consider, for example, a scenario in which interest rates spike mid-year. In this case, the principal balance in the individual retirement account automatically declines as the bond decreases in value. In contrast, the California account holder has a formula-based, fixed dollar claim against the collective assets of the California trust. If those assets go down, or up, in value, the account holder has the same claim for \$102 against the Trust since the assumed rate of interest for the year (2%) was fixed by the California board before the year began.

The story is similar if interest rates decline. In this case, the value of the bond in the individual retirement account rises to the financial advantage of the account holder as the account's balance grows in tandem with the increase in the bond's value. In contrast, the California account holder's entitlement under his notional account is the same fixed, formula-based amount of \$102 even as the value of the bond spikes due to lower interest rates. Under the Act, any investment gain from falling interest rates inures to the Trust and its collective pool, not to any account holder. The board may elect to retroactively allocate some or all of this gain to participants' accounts or may for the following year increase the stated investment return to reflect the prior year's increase in the Trust's assets. But the board need not do so.

Even if the board takes these retroactive steps, there will be no direct link between the Trust's investment performance and participants' account balances. Under the California Act, any connection between investment performance and account balances is mediated by the board through its selection of a stated rate of return and the board's decision whether or not to credit to accounts the Trust's "excess" earnings. At the end of the day, there is a significant difference between an individual retirement account, the value of which is tied directly and automatically to investment gains and losses, and a formula-driven account under the Act, which is not linked directly or automatically to investment gains or losses.

A second rebuttal to the conclusion that the accounts created by the Act are not individual retirement accounts under the Code would assert

that the definition of “account” is different for IRAs than for defined contribution plans, such as money purchase pensions and profit sharing arrangements. If so, Code § 414(i)<sup>159</sup> and the case law decided under it are irrelevant to IRAs.

However, Code § 414(i) is, by its terms, applicable, not only to money purchase and profit sharing plans, but to § 408<sup>160</sup> as well; § 414(i) applies to the “part” of the Code that includes § 408.<sup>161</sup> As a textual matter, the term “account” in § 408 is most plausibly read to mean the same thing for IRAs as for other defined contribution plans covered by the same part of the Code, i.e., a retirement account where investment gain and loss automatically and directly inure to the benefit (or detriment) of the account holder.

A third challenge, related to the second, would assert that, in the context of IRAs, it is not in practice important to define rigorously the concept of an “account.” In the context of employer-sponsored retirement plans, the distinction between defined contribution/individual account plans and defined benefit pensions is crucial for many purposes. For example, employers guarantee the benefits promised under defined benefit pensions but do not guarantee outcomes under individual account plans.<sup>162</sup> Congress has imposed limits on the employer stock a defined benefit arrangement may own, but has levied no equivalent restrictions on defined contribution plans.<sup>163</sup> There are different vesting schedules for defined contribution and defined benefit plans.<sup>164</sup> In these and other settings, it is

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<sup>159</sup> I.R.C. § 414(i) (2006).

<sup>160</sup> I.R.C. § 408 (2006).

<sup>161</sup> That part of the Code is Part I of Subchapter D which extends from Code § 401 through Code § 420, inclusive, and thus includes Code § 408, governing IRAs. See I.R.C. §§ 401-420 (2006).

<sup>162</sup> Despite its relatively narrow focus, Justice Stevens’ *Nachman* opinion is generally cited as confirming that employers guarantee defined benefit pensions. *Nachman Corp. v. Pension Benefit Guaranty Corporation*, 446 U.S. 359 (1980). As a statutory matter, it is today the minimum funding rules and the PBGC insurance arrangement which lock employers into the defined benefit commitments they make. I.R.C. §§ 412, 430, 431, 436, 4971 (2006); ERISA § 301, 29 U.S.C. § 1081 (2006) (minimum funding rules); ERISA § 4062, 29 U.S.C. § 1362 (2006) (sponsoring employers liability to PBGC in case of distress termination).

<sup>163</sup> 29 U.S.C. § 1107 (2006).

<sup>164</sup> Compare I.R.C. § 411(a)(2)(A) (2006), and 29 U.S.C. § 1053(a)(2)(A) (2006) (vesting schedules for defined benefit plans), with I.R.C. § 411(a)(2)(B) (2006), and 29 U.S.C. § 1053(a)(2)(B) (2006) (vesting schedules for defined

critical to determine which plans have “accounts” and which do not. However, the argument would conclude, there are no similar consequences in the context of individual retirement accounts and thus no need to define such accounts with particular rigor.

However, the term “account” does play an important role in the context of individual retirement arrangements as the Code distinguishes individual retirement accounts from individual retirement annuities: such annuities can only be issued by insurance companies complying with state regulation of insurance.<sup>165</sup> It is, moreover, unconvincing to read the term “account” differently at different places within the same statute. Code § 408 was enacted as part of ERISA, which simultaneously embedded the definition of an account in both Code § 414 and the labor, i.e., Title 29, version of ERISA.

A fourth argument would contend that California could defend the Act in its current form by asserting that the Act’s notional accounts fall within the Code’s authorization of individual retirement annuities. If the Act’s notional accounts can, for purposes of the Code, be characterized as such annuities, then it is unnecessary for those accounts to comply with the Code and ERISA requirement that accounts allocate investment gains and losses to account holders.

It is no accident that the drafters and sponsors of the Act elected to characterize the participants’ interests in the California program as “accounts.” By labeling those interests as “accounts,” the proponents of the Act appealed to the broad public acceptance of the now-established defined contribution paradigm with its emphasis on account-based ownership devices<sup>166</sup> such as 401(k) accounts,<sup>167</sup> individual retirement accounts,<sup>168</sup> Section 529 accounts,<sup>169</sup> and health savings accounts.<sup>170</sup> In contrast, despite the persuasive argument for annuities as savings and retirement devices,<sup>171</sup> such annuities do not resonate the same way with the public today. Would a majority of the Golden State’s legislators have been

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contribution plans).

<sup>165</sup> I.R.C. § 408(b) (2006).

<sup>166</sup> Zelinsky, *supra* note 66, at 31-37.

<sup>167</sup> *Id.* at 49-52.

<sup>168</sup> *Id.* at 52-58.

<sup>169</sup> *Id.* at 64-69.

<sup>170</sup> *Id.* at 62-64.

<sup>171</sup> *Id.* at 15-23; TERESA GHILARDUCCI, WHEN I’M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM 122-25 (2008).



willing to impose mandatory “annuities” on their constituents? I’m skeptical. Framing matters.<sup>172</sup>

Against this background, it is unpersuasive for California to call the notional accounts created in the Act “accounts” when addressing the California populace through the Golden State’s statute books while simultaneously telling the IRS, the DOL, and, ultimately, the courts that these “accounts” are really “annuities” under the Code.

Moreover, if the Act’s accounts are individual retirement annuities for purposes of the Code, those putative annuities cannot be offered by the Trust created under the Act. As a statutory matter, individual retirement annuities must be underwritten by insurance companies, complying with the state’s statutes and regulations pertaining to insurance.<sup>173</sup> However, the Trust is not required to comply with the insurance statutes and regulations of the Golden State.<sup>174</sup>

Just as the defenders of the Act might be tempted in *ipse dixit* fashion to declare the Act’s accounts as annuities, they might also be tempted to proclaim arbitrarily that the Trust is an insurance company even though the Trust need not comply with the same rules as apply to commercial and nonprofit insurers operating in the Golden State.<sup>175</sup> Such a formalistic, indeed hollow, relabeling of the Trust as an insurance company would be unpersuasive. The evident purpose of the statutory

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<sup>172</sup> Scholars today give much attention to “framing effects.” At one level, the research on framing effects itself reframes the long-recognized reality that it matters how issues are defined. For contemporary research on framing effects, see Edward A. Zelinsky, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and The Paradox of Tax Expenditure Analysis*, 24 VA. TAX REV. 797, 807-11 (2005); Edward J. McCaffery & Joel Slemrod, *Toward an Agenda for Behavioral Public Finance*, in BEHAVIORAL PUBLIC FINANCE 3, 7-8 (Edward J. McCaffery and Joel Slemrod eds., 2006). For a classic instance of an astute politician who understood what we today call framing effects in the context of retirement policy, see ZELINSKY, *supra* note 66, at 113 (discussing Franklin D. Roosevelt’s decision to finance Social Security through payroll taxes so “no damn politician can ever scrap my social security program.”).

<sup>173</sup> See I.R.C. § 408(b) (2006) (individual retirement annuities must be “issued by an insurance company”); Treas. Reg. § 1.408-3(a) (1986) (individual retirement annuities must be “issued by an insurance company which is qualified to do business under the law of the jurisdiction in which the contract is sold.”); see generally CAL. INS. CODE.

<sup>174</sup> See generally CAL. INS. CODE.

<sup>175</sup> *Id.*

requirement of Code § 408(b) is to assure the holders of individual retirement annuities that those annuities receive the substantive protections of state insurance law. That purpose is eviscerated if an entity, like the Trust, is by *ipse dixit* declared to be an insurance company while relieved of the substantive requirements governing all other insurers.

At the end of the day, California's legislature elected to characterize the Act's accounts as accounts rather than as annuities and chose to offer those accounts through a state-sponsored Trust rather than through insurance companies complying with California's insurance laws. California should be held to those choices. And the notional accounts created by the Act do not qualify as individual retirement accounts since they do not allocate gains and losses to account holders.<sup>176</sup>

Yet a fifth challenge to my conclusion that the Act's accounts are not individual retirement accounts would dispute the similarity of the California program to a cash balance-style defined benefit plan. If the assets funding a cash balance pension are inadequate to pay promised benefits, the sponsoring employer is liable for the shortfall.<sup>177</sup> However, California has explicitly disclaimed responsibility for any liabilities of the Trust or the program<sup>178</sup> – a disclaimer not available to the private sector sponsor of a defined benefit plan. Similarly, if there are surplus assets in a cash balance plan when the plan terminates, these assets may revert to the sponsoring employer.<sup>179</sup>

An analogy need not be perfect to be persuasive. Even if we take at face value California's declaration that the Golden State's treasury does not stand behind the Trust and the program,<sup>180</sup> the accounts to be established under the Act are notional in nature. Like a participant in a cash balance pension, a participant in the California program will have a formula-based claim against the Trust rather than a true individual account under which investment gains automatically flow through to the

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<sup>176</sup> As I discuss *infra*, another state (or even California itself) could pursue a different course from the Act by openly declaring that private sector employees otherwise without work-based retirement savings coverage must purchase individual retirement annuities. See *infra* note 247 and accompanying text.

<sup>177</sup> See ZELINSKY, *supra* note 66, at 14.

<sup>178</sup> S.B. 1234, 2012 Leg., Reg. Sess. (Cal. 2012) (amending CAL. GOV'T CODE §§ 100013, 100014(c)(3), and 100036 (2012)).

<sup>179</sup> Subject to the potential reversion tax of I.R.C. § 4980 (2006).

<sup>180</sup> S.B. 1234 (Cal. 2012) (amending CAL. GOV'T CODE §§ 100013, 100014(c)(3), and 100036 (2012)).

participant's account and losses reduce the participant's account balance.

The Act is silent as to the distribution of surplus assets if the Trust were to terminate in overfunded condition. Perhaps the Trust's extra funds would be distributed to present and/or former participants in the program. Or perhaps these surplus assets would go to the California treasury in a manner analogous to a reversion to an employer sponsoring a defined benefit plan. We don't know. In any event, the program and its accounts need not perfectly mimic a private sector cash balance pension for such a pension to be the most useful analogy. That is the case, given the cash balance-style, formula-based entitlement of account holders under the California Act.

A sixth argument is that there is no policy reason to deny individual retirement account status to the accounts to be established under the Act. A believer in the ownership society would disagree, arguing that true individual accounts correspond with cultural norms about ownership and give the account holder a direct stake in the American economy as a result of his unmediated participation in the upside and downside of investment performance.<sup>181</sup>

Had the 93<sup>rd</sup> Congress foreseen the possibility of cash balance accounts, it might have drafted Code § 408 to include within the definition of an individual retirement account the kind of defined benefit, notional account established under the California Act. But Congress did not. It is anachronistic to blame Congress for this omission (assuming it was an omission) because the cash balance plan was far in the future and could not have been anticipated in 1974. It is, moreover, not apparent that, had the drafters foreseen the possibility of formula-based cash balance accounts, they would have included them within the definition of individual retirement accounts for purposes of Code § 408. In any event, Congress did not draft Code § 408 in a way which qualifies cash balance accounts as individual retirement accounts since cash balance accounts are formula-based and do not allocate investment gains and losses directly to participants' respective accounts.

Consider finally my argument that the private insurance the Act authorizes the board to purchase is analogous to the insurance the PBGC issues to defined benefit pension plans to protect against the underfunding of promised benefits. This similarity, I argue, indicates that the accounts authorized by the California Act are defined benefit devices, insurable like

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<sup>181</sup> ZELINSKY, *supra* note 66, at 97-101.

defined benefit pensions, and thus outside the statutory definition of an individual retirement account: insurance is only needed against the risk of underfunding when underfunding can occur. Defined contribution accounts cannot be underfunded since account holders are entitled to whatever their respective accounts are worth, based on actual investment performance.

The counterargument is that the insurance authorized by the Act is similar to an insurance-type product purchased inside an individual retirement account. Such accounts, for example, can invest in guaranteed income contracts (GIC), which, the argument goes, are similar to the insurance the board can buy under the Act.

The controlling difference is the nature of the claim created by an insurance-type product inside an individual retirement account, as opposed to insurance protecting a formula-based benefit. When an individual retirement account is invested in a GIC or similar device, the account holder's entitlement is defined and limited by that contract. If the insurer or other financial institution issuing the GIC defaults, the account holder has no further claim against the account. The GIC (or similar insurance-type device) is an investment like a bond or stock: if the GIC goes belly-up, the loss falls on the individual account holder.

However, the insurance to be purchased under the Act is designed to guarantee a cash balance-style defined benefit formula, i.e., the employees' contributions increased by a stated rate of return, unreduced by investment losses. If the issuer of the insurance acquired by the board defaults, the account holder still has a claim against the Trust for his formula-based benefit. Again, the analogy, while not perfect, is instructive. The insurance to be purchased by the California board underwrites a cash balance-style benefit just as the PBGC issues insurance to protect the equivalent formula-based promises made by defined benefit plans.

#### D. SUMMARY

In sum, the Act imposes investment reward and risk on the Trust and the collective funds the Trust will hold. The cash balance-style accounts created by the Act are proclaimed by the Act to be "accounts." However, these notional accounts are not individual retirement accounts since the account holder has a formula-based defined benefit-type interest in his account and does not himself benefit directly from good investment performance or suffer from poor investment performance.

VII. NO ERISA PREEMPTION UNDER *TRAVELERS* OF THE ACT'S  
EMPLOYER MANDATE

Under the Act, the board can only implement the program if the accounts implementing the program qualify as individual retirement accounts under the Code.<sup>182</sup> This caveat reflects the drafters' intent for the program to qualify as an IRA payroll deduction arrangement, subject to state regulation because such an arrangement is not an employee benefit plan for ERISA purposes.<sup>183</sup> This caveat also assures the participants in the program that they will receive the tax benefits associated with IRAs.<sup>184</sup>

Because the accounts established under the Act are not individual retirement accounts, the most compelling course for California's legislature would be to abandon the cash balance-style formula currently embedded in the Act by amending the Act to recast the accounts to be offered by the program as true individual retirement accounts which assign investment risk and reward directly to the participating employees. It is thus necessary to consider whether, if the Act were so amended,<sup>185</sup> the Act's employer mandate would be ERISA preempted. *Shaw* says "yes" while *Travelers* says "no." *Travelers*, as the Court's more recent and more compelling construction of § 514(a) and ERISA preemption, should control and should thus protect the employer mandate of the California Act from ERISA preemption – if the Act's accounts are reformulated as bona fide individual retirement accounts.

The Act's employer mandate explicitly refers to employer-sponsored retirement plans, exempting from the mandate all Golden State employers who sponsor such plans.<sup>186</sup> Under the unforgiving *Shaw* test ("connection with or reference to"), ERISA § 514(a) preempts the Act's employer mandate since that mandate refers to employers' retirement plans by exempting from the mandate employers sponsoring retirement plans for

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<sup>182</sup> S.B. 1234 (Cal. 2012) (amending CAL. GOV'T CODE §§ 100013, 100014(c)(3), 100036 (2012)).

<sup>183</sup> 29 C.F.R. §2510.3-2(d) (2007).

<sup>184</sup> I.R.C. §§ 219, 408(e)(1) and 408A(d)(1) (2006).

<sup>185</sup> In order for the program accounts established under the Act to qualify as individual retirement accounts, it is also necessary for the Trust to satisfy the IRS that the Trust will be administered in a fashion "consistent with the requirements of" I.R.C. § 408. See I.R.C. § 408(a)(2) (2006). It should not be difficult for the Trust to satisfy this standard. See Treas. Reg. § 1.408-2(e) (1986).

<sup>186</sup> S.B. 1234 (Cal. 2012) (amending CAL. GOV'T CODE § 100032(d) (2012)).

their respective workforces.

Consider in this context the last of the *Shaw* line of cases, *District of Columbia v. Greater Washington Board of Trade*.<sup>187</sup> In that case, the U.S. Supreme Court declared as ERISA-preempted a District of Columbia law requiring employers to provide to injured employees receiving workers' compensation the same health insurance employers provide to their active workers. Since employer-provided medical coverage constitutes an ERISA-governed employee benefit plan,<sup>188</sup> the Court held, the D.C. law impermissibly "refer[red] to" such ERISA-regulated employee benefit plans by requiring that injured employees receive the same medical coverage as furnished by the ERISA-regulated employee benefit plans in effect for active employees.

The application of *Greater Washington Board of Trade* to the California Act's employer mandate is straightforward: like the D.C. statute the Court held to be preempted, the California Act explicitly refers to employers' ERISA-regulated employee benefit plans, exempting from the obligation to participate in the Act's state-sponsored withholding program any employer which maintains a retirement plan for its employees.<sup>189</sup> Thus, under the unforgiving *Shaw* test ("reference to"), the Act's employer mandate is ERISA-preempted as the mandate refers to employer-sponsored retirement plans by exempting employers maintaining such plans – just as the District of Columbia statute referred to employer-sponsored medical plans for active employees as the standard for medical coverage to be provided to injured employees.

*Travelers*, however, undermines *Shaw*. Under *Travelers*' approach to § 514(a), the Act's employer mandate is not ERISA-preempted. Underlying *Travelers*' approach to ERISA § 514(a) are a variety of themes which cannot be reconciled with *Shaw*: the interpretation of § 514(a) in any situation, *Travelers* declares, starts with the "presumption that Congress does not intend to supplant state law."<sup>190</sup> The legislative purpose animating ERISA's preemption provision was "to avoid a multiplicity of [state] regulation in order to permit the nationally uniform administration of employee benefit plans."<sup>191</sup> Such national uniformity is particularly at risk when a state law dictates "employee benefit structures or their

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<sup>187</sup> 506 U.S. 125 (1992). See Zelinsky, *supra* note 91, at 826.

<sup>188</sup> 29 U.S.C. 1002(1) (2006).

<sup>189</sup> S.B. 1234 (Cal. 2012) (amending CAL. GOV'T CODE § 100032(d) (2012)).

<sup>190</sup> *Travelers*, 514 U.S. at 654.

<sup>191</sup> *Id.* at 646.

administration”<sup>192</sup> or provides “alternative enforcement mechanisms.”<sup>193</sup> A state law is not ERISA-preempted under § 514(a) merely because of its “indirect economic influence” on employee benefit plans.<sup>194</sup> Starting from these *Travelers* premises, the Act’s employer mandate is not ERISA-preempted because there is a presumption that Congress preferred not to supplant the Act, the Act’s employer mandate has no effect on employers maintaining their own retirement plans for their employees, and the Act’s mandate does not impair national uniformity in the administration or content of employer-sponsored retirement plans. Indeed, the Act says nothing about such administration or content.

To explore further the contrast between *Shaw* and *Travelers*, consider the Supreme Court’s first ERISA preemption decision after *Travelers*, *California Division of Labor Standards Enforcement v. Dillingham Construction, N.A., Inc.*<sup>195</sup> Separately-funded apprenticeship programs are ERISA-regulated employee welfare plans.<sup>196</sup> On public construction projects, California law permits contractors to pay lower than prevailing wages to apprentices only if the state approves the apprenticeship program. Under *Shaw*, this California statute refers to and has a connection with ERISA-governed welfare plans, namely separately-funded apprenticeship programs. Hence, applying *Shaw*, the California wage law should be preempted under ERISA § 514(a).

However, following *Travelers*, the *Dillingham* Court sustained the California wage statute as that statute merely had an “indirect economic influence”<sup>197</sup> on ERISA-regulated apprenticeship programs in the Golden State. The impact of the California law was “quite remote”<sup>198</sup> from concerns about plan benefits and plan administration. Hence, the *Dillingham* Court declared, ERISA did not preempt the California statute challenged in that case. *Dillingham* thus buttresses the conclusion that, under *Travelers*’ more forgiving approach, the Act’s employer mandate is not ERISA-preempted.

While less sweeping than *Shaw*, post-*Travelers* ERISA preemption still has substantial bite in particular cases. In *Egelhoff v. Egelhoff ex. rel.*

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<sup>192</sup> *Id.* at 658

<sup>193</sup> *Id.*

<sup>194</sup> *Id.* at 659.

<sup>195</sup> 519 U.S. 316 (1997).

<sup>196</sup> 29 U.S.C. § 1002(1) (2006).

<sup>197</sup> *Dillingham*, 519 U.S. at 329.

<sup>198</sup> *Id.* at 330.

*Breiner*,<sup>199</sup> for example, the Court held that § 514(a) prevents the application to any ERISA-governed employee benefit plan of a Washington State statute that, on a participant's divorce, automatically revokes any beneficiary designation of the participant's former spouse. The Washington law, the *Egelhoff* Court declared, "interferes with nationally uniform plan administration" of ERISA-regulated plans<sup>200</sup> by requiring an employee benefit plan operating in Washington State to disregard a beneficiary designation on file with such plan if the designation names a former spouse as beneficiary.

In contrast, the Act has no impact on California employers maintaining retirement plans or payroll deduction IRA arrangements. These employers can with impunity ignore the Act, the Trust, and the program. The Act does not regulate the content or processes of a California employer's retirement plan or an employer's IRA payroll deduction arrangement. If a California employer is required to enroll in the program (assuming the Act is amended to qualify the Act's accounts as individual retirement accounts), the employer will thereby participate in a program which is not an employee benefit plan for ERISA purposes: California's state-sponsored program (assuming amendment of the Act) will qualify as a payroll deduction IRA arrangement which is not an employee benefit plan under ERISA.<sup>201</sup>

For ERISA preemption purposes, the Act (if amended to establish bona fide individual retirement accounts) is more like the California apprentice wage statute sustained in *Dillingham* than the Washington State divorce-related law stricken in *Egelhoff*. The latter unacceptably impinged upon the administration of ERISA-regulated plans by requiring

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<sup>199</sup> 532 U.S. 141 (2001). For discussion of *Egelhoff*, see Edward A. Zelinsky, *Employer Mandates and ERISA Preemption: A Critique of Golden Gate Restaurant Association v. San Francisco*, 50 STATE TAX NOTES 503, 512 (2008) (hereinafter Zelinsky, *Golden Gate II*); Edward A. Zelinsky, *Egelhoff, ERISA Preemption and the Conundrum of the 'Relate To' Clause*, 91 TAX NOTES 1917 (2001).

<sup>200</sup> *Egelhoff*, 532 U.S. at 148.

<sup>201</sup> By way of contrast, an employer subject to the employer mandate of the San Francisco Health Care Security Ordinance must provide specific health care benefits under its own, ERISA-regulated program, or, in the alternative, must participate in the City's Health Access Program (HAP), which establishes an ERISA-governed health care program. See Zelinsky, *Golden Gate II*, *supra* note 199, at 4-7.



administrators to run their respective plans in accordance with Washington State law rather than the pre-divorce beneficiary designations on file with the plan. The California Act, in contrast, does not impinge upon employers' retirement plans or such plans' operations. The Act just requires employers without such plans or IRA withholding arrangements to participate in a state-sponsored IRA withholding program, a program which is not an employee benefit plan for ERISA purposes.<sup>202</sup>

As the Court's later and more persuasive<sup>203</sup> interpretation of ERISA preemption, *Travelers* should prevail over *Shaw*. Thus, the Act's employer mandate should survive ERISA preemption if the Act's accounts are recast as individual retirement accounts. Per *Travelers*, the Act has no direct effect on employers' retirement plans and does not affect the content or administration of such plans. The Act will merely require employers without retirement plans to maintain their own IRA payroll arrangements or to participate in the California program, a publicly-administered IRA payroll arrangement which is not an employee benefit plan for ERISA purposes.

#### VIII. NO ERISA PREEMPTION OF EMPLOYER CONTRIBUTIONS UNDER *TRAVELERS*

Similar observations apply as to the provisions of the Act authorizing employers to make voluntary contributions<sup>204</sup> to employees' program accounts: under *Shaw*, this portion of the Act is ERISA-preempted, but, under *Travelers*, the Act's authorization of optional employer contributions survives § 514(a) scrutiny. *Travelers* is the Court's later and more compelling interpretation of § 514(a) and thus should spare from ERISA preemption the Act's authorization of supplemental employer contributions. The Act neither requires employers to make contributions nor requires employers to affirmatively elect against such contributions.

The employer who makes voluntary contributions under the Act to employees' accounts will, by virtue of such contributions, convert the

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<sup>202</sup> 29 CFR § 2510.3-2(d) (2010).

<sup>203</sup> Despite these rulings the author continues to believe that there is an interpretation of ERISA § 514(a) which is better than either *Shaw* or *Travelers*, namely, to treat § 514(a) as creating a rebuttable presumption of ERISA preemption. See Zelinsky, *supra* note 91, at 839-58.

<sup>204</sup> S.B. 1234, 2012 Leg., Reg. Sess. (Cal. 2012) (amending CAL. GOV'T CODE §§ 100004(e) and 100012(j) (2012)).

program for such contributing employer from a payroll deduction IRA arrangement into an ERISA-regulated employee benefit pension plan. Payroll deduction IRA arrangements retain that classification only if the employees make all contributions pursuant to such arrangements.<sup>205</sup> If a California employer makes contributions under the program, the program would for ERISA purposes thereby become an employee pension plan for that employer, an employer-financed plan which both “provides retirement income to employees”<sup>206</sup> and which “results in a deferral of income by employees.”<sup>207</sup> Employers making supplemental contributions to employees’ accounts under the Act would need to comply with the rules for either a simplified employee pension<sup>208</sup> (SEP) or a simple retirement account<sup>209</sup> (SRA). Either way, an employer’s contributions to the program would result for that employer in a pension plan for ERISA purposes, an employer-financed arrangement providing retirement income and deferring income.<sup>210</sup>

*Shaw* preempts the Act insofar as the Act would take California employers down the path of employer contributions. As to contributing employers, the state-run program and the Trust will be an ERISA-governed pension plan because of such employers’ contributions to the program. Under *Shaw* and its nearly automatic standard for ERISA preemption, the Act would have the ultimate “connection with” an ERISA-regulated employee benefit plan: the Act would create such a plan whenever employers make supplemental contributions to employees’ accounts as

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<sup>205</sup> 29 C.F.R. § 2510.3-2(d) (2010).

<sup>206</sup> 29 U.S.C. § 1002(2)(A)(i) (2006).

<sup>207</sup> 29 U.S.C. § 1002(2)(A)(ii) (2006).

<sup>208</sup> I.R.C. § 408(k) (2006). S.B. 1234 adds to the Government Code § 100010(b), which requires the board to promulgate regulations “to ensure that the program meets all criteria for federal tax-deferral or tax-exempt benefits, or both.” S.B. 1234 (Cal. 2012) (amending CAL. GOV’T CODE § 100010(b) (2012)). This statutory requirement would mandate regulations qualifying voluntary employer contributions under the program to take the form of either simplified employee pensions or simple retirement accounts.

<sup>209</sup> I.R.C. § 408(p) (2006).

<sup>210</sup> While governmental plans are largely immune from regulation under ERISA, the program created under the Act is not a governmental plan for purposes of ERISA since the program covers employees in the private and nonprofit sectors, not the employees of governments. *See* 29 U.S.C. § 1002(32) (1974) (defining governmental plans as covering government employees); 29 U.S.C. § 1003(b)(1) (1974) (stating that Title I of ERISA does not apply to governmental plans).

such employers' contributions under the Act would, for ERISA purposes, convert their payroll deduction arrangements into employee benefit plans.

Consider in this context the Supreme Court's *Shaw*-based decision in *FMC Corp. v. Holliday*.<sup>211</sup> In *FMC Corp.*, the Court held that ERISA § 514(a) preempts Pennsylvania's anti-subrogation law from applying to self-insured<sup>212</sup> welfare plans. If, as *FMC Corp.* holds, a state law regulating employee benefit plans impermissibly "relate[s] to"<sup>213</sup> the plans the law regulates, a fortiori a state law that creates employee benefit plans is similarly ERISA-preempted as relating to the plans it creates. Hence, under the *Shaw* framework, the California Act, insofar as it establishes an ERISA-governed pension plan for employers' contributions, has an impermissible "connection with"<sup>214</sup> the employee pension plans the Act thereby establishes.

Again, however, the *Travelers* approach to ERISA-preemption is more forgiving, permitting state laws which have "indirect economic effects" on employers' retirement plans as long as such laws do not impair the nationally uniform content or administration of such plans. The Act's authorization of supplemental employer contributions does not impair national uniformity in the structure or administration of employee benefit plans. Any California employer can ignore the Act's authorization of optional employer contributions. The Act thus has no impact, indirect or otherwise, on such employers.

In two respects, *Egelhoff* is instructive in this context and confirms that, under the more forgiving approach to ERISA preemption inaugurated in *Travelers*, the provisions of the California Act authorizing supplemental employer contributions are distinguishable for ERISA preemption purposes from the Washington State statute the Court struck in *Egelhoff*. First, writing for the *Egelhoff* Court, Justice Thomas observed of the Washington State statute revoking beneficiary designations on divorce that "[u]niformity is impossible . . . if plans are subject to different legal obligations in different states."<sup>215</sup> In contrast, the California Act's authorization of voluntary employee contributions imposes no "legal obligations" on any California employer, as the Act does not require a

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<sup>211</sup> 498 U.S. 52 (1990). See Zelinsky, *supra* note 91, at 822-23.

<sup>212</sup> The Pennsylvania law survived preemption as to insured ERISA plans as a permitted regulation of insurance. See *FMC Corp.*, 498 U.S. at 60.

<sup>213</sup> 29 U.S.C. § 1144(a) (2006).

<sup>214</sup> *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 96-97 (1983).

<sup>215</sup> *Egelhoff v. Egelhoff ex rel. Breiner*, 532 U.S. 141, 148 (2001).

California employer to make contributions. The Act simply permits supplemental contributions by an employer that elects to make such optional contributions. No California employer is legally obligated to make voluntary contributions – unlike the Washington State employers in *Egelhoff* who were legally required to follow that state’s law revoking beneficiary designations of former spouses.

Second, an employer in Washington State can elect “to opt out”<sup>216</sup> of the Washington State statute revoking beneficiary designations on divorce. As Justice Thomas pointed out, this “opt out” option, if replicated by other states, would threaten nationally uniform administration of ERISA-regulated plans by requiring an interstate employer to opt out state-by-state. Thus, if the Washington State statute at issue in *Egelhoff* were reproduced nationwide, “the burden” of opting out of each state’s statute would be “hardly trivial”.<sup>217</sup> As to the Washington law,

[i]t is not enough for plan administrators to opt out of this particular statute. Instead, they must maintain a familiarity with the laws of all 50 States so that they can update their plans as necessary to satisfy the opt-out requirements of other, similar statutes.<sup>218</sup>

In contrast, a California employer need not elect against supplementary contributions under the Golden State’s Act. A California employer who is ignorant of the optional contributions authorized by the Act suffers no consequences. A nationwide employer could similarly ignore the voluntary employer contributions permitted by any other state statute modeled on the California Act. An employer need not “opt out” of a statute when compliance with that statute is voluntary – as is compliance with the California Act’s provisions permitting, but not requiring, supplementary employer contributions.

Thus, at the end of the day, whether ERISA preempts the California Act’s authorization of optional employer contributions depends (as does the ERISA preemption status of the Act’s employer mandate) upon the standard used to interpret ERISA § 514(a). Under the older, more sweeping *Shaw* test (“reference to or connection with”), ERISA

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<sup>216</sup> *Id.* at 150.

<sup>217</sup> *Id.* at 151.

<sup>218</sup> *Id.*

preemption of state law is nearly automatic. By authorizing optional employer contributions, the California Act connects with employers' ERISA-regulated employee benefit plans by creating such plans when employers make optional contributions. *Shaw* thus counsels that § 514(a) preempts the Act's authorization of voluntary employer contributions as such employer contributions would convert the program created under the Act from an IRA payroll deduction arrangement without employer contributions into an ERISA-regulated employee pension plan with such contributions.

However, *Travelers'* more forgiving approach to ERISA preemption protects the Act's authorization of supplemental employer contributions under § 514(a). The California Act neither obligates employers to make voluntary contributions nor requires employers to affirmatively reject an obligation to make such contributions. Thus, the Act's authorization of optional employer contributions survives under the Supreme Court's more recent and more persuasive articulation of ERISA preemption in *Travelers*: employer contributions convert the program into an employee pension plan for ERISA purposes, but the Act imposes no obligations on employers which, under the more forgiving standards of *Travelers*, would trigger ERISA preemption.

Just as it is necessary to amend the Act to convert its notional, cash balance-style accounts into individual retirement accounts, it is also necessary to amend the Act's prohibition on supplementary employer contributions if such contributions "cause the program to be treated as an employee benefit plan under" ERISA.<sup>219</sup> The drafters of this provision evidently concluded that, if employer contributions convert the Golden State's program into an employee benefit plan for ERISA purposes, ERISA preemption necessarily follows.

*Travelers* points to a different conclusion: even though for ERISA purposes employer contributions convert the California program into an employee benefit plan for the employers making such optional contributions, the Act is not ERISA-preempted under *Travelers*. The employer contributions authorized under the Act are purely voluntary. The Act imposes no burden on California employers with respect to their retirement plans or with respect to the design or administration of their retirement plans. Hence, per *Travelers*, ERISA does not prohibit employer

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<sup>219</sup> See CAL. GOV'T CODE §100004(e) (2012); CAL. GOV'T CODE §100012(k) (2012).

contributions under the program, even though such contributions convert the program to an employee pension plan for ERISA purposes. The Act should accordingly be amended to delete the Act's current requirement that employer contributions be suspended if they would "cause the program to be treated as an employee benefit plan under" ERISA.

#### IX. OTHER CHOICES

The foregoing analysis indicates that the Act would survive ERISA-preemption under *Travelers* were the Act amended to recast the California program's accounts as individual retirement accounts which allocate investment reward and loss to the individual account holder. If the Act were so amended, an employer's withholding under the California program would qualify as an IRA payroll deduction arrangement which is, for ERISA purposes, not an employee benefit plan since only amounts withheld from the employees' wages would be paid to the Trust. If any California employers make optional contributions under the Act, for those contributing employers, the program would become an employee pension plan, but would survive ERISA-preemption under *Travelers*. Under the older and tougher *Shaw* standard, the Act's employer mandate is ERISA-preempted, whether or not the employer makes supplementary contributions under the program. However, *Travelers* is the Court's later and more compelling construction of ERISA § 514(a),<sup>220</sup> the Act, if amended to convert its formula-based notional accounts into individual retirement accounts, should survive ERISA preemption under *Travelers* since the Act would impose no obligations or burdens on employers and their retirement plans.

That the Act, as amended, would be legal does not mean that the Act, as amended, would be sound policy. In this final section, I outline some of the alternatives available to a state legislature (or a Congress) that contemplates following California's lead in encouraging retirement savings.

Any such outline starts with the fact that there is, as the Act's advocates observe, a serious problem, namely the failure of moderate and low-income workers to save for retirement. Some critics of the California

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<sup>220</sup> However, I continue to believe that there is a better approach to ERISA § 514(a) than either *Shaw* or *Travelers*, namely, construing § 514(a) as creating a presumption of preemption. See Zelinsky, *supra* note 102, at 839-58.

Act portray the Act as an effort to grab private savings to rescue underfunded pensions for public employees.<sup>221</sup> Even if that is so, the Act on its face is aimed at a real shortcoming in our national retirement system. Our defined contribution culture places the burden of retirement saving on the worker himself. Most low- and moderately-paid workers save little or nothing for retirement.<sup>222</sup>

Other commentators on the Act raise the opposite fear, namely that California's taxpayers will be seen as implicitly guaranteeing the cash balance-style defined benefits promised to participating employees under the Act in its current form.<sup>223</sup> From this vantage, the ultimate risk down the road is not using private retirement savings to rescue public pensions, but requiring the public treasury to make good future underfunding of the notional, cash balance-style accounts created under the Act.

Both risks are mitigated if, as I urge, the Act's current notional, cash balance accounts are changed to true individual accounts which allocate directly investment risk and reward to the employee/account holders. If the Act's accounts are converted to individual retirement accounts, there would be no underfunding for California's taxpayers to finance since an individual retirement account holder is simply entitled to his or her account's current total, whatever that total may be in light of investment gains and losses. Moreover, it would be more difficult politically for a future legislature to divert funds from a Trust consisting of accounts under which each account holder, as an individual retirement account owner, has a claim for his particular investment-based balance rather than a fixed, formula-based benefit. As noted above, framing

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<sup>221</sup> See, e.g., Mimi Walters, *The Government Seizure of Private Retirement Plans*, FOX & HOUNDS (Sept. 19, 2012), <http://www.foxandhoundsdaily.com/2012/09/the-government-seizure-of-private-retirement> (“SB 1234 looks like nothing more than a cynical effort to prop up the floundering public employee pension debt with new funds from private investors . . .”).

<sup>222</sup> LANGBEIN ET AL., *supra* note 6, at 26-27; FROLIK AND MOORE, *supra* note 103, at 5; see DEP'T OF THE TREASURY, *supra* note 5, at 124; see also S.B. 1234, 2012 Leg., Reg. Sess. (Cal. 2012) (adding § 100008(c) to the CAL. GOV'T CODE (2012)). (“[O]ver 6.3 million California workers, 75 percent of whom earn less than \$50,000 per year, do not have access to retirement savings opportunities through their jobs.”).

<sup>223</sup> Keegan, *supra* note 86; Danker, *supra* note 86; Lin, *supra* note 86; DeLeon, *supra* note 87.

matters.<sup>224</sup> And it would matter to an account holder if his balance were reduced by a future legislature's diversion of assets to buttress public employees' pension plans.

Not every problem has a solution nor is the solution to every problem a statute or a public program. However, the supporters of the Act raise a compelling concern when they point to the systematic failure of less affluent workers to save adequately for retirement.

I conclude that, in this area, Brandeisian experimentation<sup>225</sup> by the states is desirable, both to test different models (including the model of no state action) and to respond to different preferences (including a preference for no state action).<sup>226</sup>

To take one example, automatic enrollment is an area where state-by-state experimentation could prove productive. It is plausible for the California Act to let workers opt out of the program's coverage. If a low- or moderate-income worker finds her current cash needs too pressing to make retirement savings, that is a regrettable decision with long-term costs, though it is reasonable to let the worker make that decision for herself. On the other hand, if a state legislature with more paternalistic instincts were to make retirement savings mandatory with no ability to opt out, the resulting experiment might produce useful information. While I am skeptical of such paternalism, a preference for state experimentation entails an openness to experiments about which one is not particularly enthusiastic.

At the other end of the spectrum, an equally plausible choice is for states to continue to do nothing about the problem of private retirement savings. There is a vigorous market in retirement products, plans, and services,<sup>227</sup> the federal government gives tax credits to both small

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<sup>224</sup> See sources cited *supra* note 172.

<sup>225</sup> The classic statement of the states as laboratories for experimentation is Justice Brandeis's dissent in *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932).

<sup>226</sup> My predisposition for state experimentation leads me to skepticism about ERISA preemption, which, even under *Travelers*, emphasizes national uniformity. See Zelinsky, *supra* note 102, at 865-68; Zelinsky, *Golden Gate II*, *supra* note 199, at 514.

<sup>227</sup> Indeed, the financial services industry has been the sales force for the defined contribution paradigm, providing services, investments and plans. Zelinsky, *supra* note 66, at 51-52, 96-97.



employers establishing qualified plans<sup>228</sup> and to low-income individuals undertaking retirement savings.<sup>229</sup> A state legislator concerned about the negligible retirement savings of rank-and-file workers could reasonably conclude that these market-based alternatives and federal tax credits occupy the field to the exclusion of any state-based policies.

Alternatively, that legislator could conclude that the state, instead of enacting a California-style Act, should supplement the federal tax credits for employers and workers with state tax credits, just as some states supplement the federal earned income tax credit<sup>230</sup> with an additional state tax credit on earned income.<sup>231</sup> Or that legislator could instead define the problem as lack of knowledge and conclude that the appropriate state policy is to publicize the federal tax credits for small employers establishing qualified plans and for low-income workers who save for their respective retirements.<sup>232</sup>

Among the interesting features of the California Act is the prospect<sup>233</sup> (some would say, inevitability)<sup>234</sup> that CalPERS, the state pension plan for the Golden State's public employees, will invest part or all of the funds held by the Trust for private sector workers. If the legislature proceeds with the Trust retaining the Act's notional, cash balance-style accounts, having a state pension fund take responsibility for the Trust's investments increases the risk that a future legislature will be compelled to use taxpayer funds to cure any shortfall. Even though the California legislature has explicitly disclaimed any state guarantee of the program's accounts,<sup>235</sup> if CalPERS (or another public agency) oversees the investment of employees' withheld wages, at least some participants in the

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<sup>228</sup> I.R.C. § 45E (2006).

<sup>229</sup> I.R.C. § 25B (2006).

<sup>230</sup> I.R.C. § 32 (2006).

<sup>231</sup> See, e.g., N.Y. TAX LAW § 606(d) (McKinney 2014); Marc Heller, *State Battles Loom on Earned Income Tax Credit, Consultants Tell Staffers*, BLOOMBERG BNA DAILY TAX REPORT, Jan. 25, 2013, at G-1.

<sup>232</sup> The California Act authorizes the board in charge of the program and Trust to "[d]isseminate information" about these federal tax credits. S.B. 1234, 2012 Leg., Reg. Sess. (Cal. 2012) (adding § 100012(e) to the CAL. GOV'T CODE (2012)).

<sup>233</sup> S.B. 1234 (Cal. 2012) (adding § 100004(c) to the CAL. GOV'T CODE § (2012)).

<sup>234</sup> Keegan, *supra* note 86.

<sup>235</sup> S.B. 1234 (Cal. 2012) (adding §§ 100013, 100014(c)(3), 100036 to the CAL. GOV'T CODE (2012)).

state-sponsored program will conclude that the state which, through its pension fund, directs the investment of their retirement savings stands behind the investment performance of the state's own agency. The disclaimer of state liability the California legislature placed in the Act<sup>236</sup> can be eliminated by a future legislature. There will be greater political pressure to cure any future shortfall with tax-generated funds if the California's own pension fund fails to achieve the stated, cash balance-style return promised to program participants by the board.

Even if the California legislature amends the Act to create true individual retirement accounts or another state's legislature modifies California's approach to create such accounts, state pension funds have not been without their own problems.<sup>237</sup> Moreover, if bona fide individual retirement accounts were invested by CALPERs or another state agency, some account holders will likely conclude that the state is, at some level, a guarantor of adequate investment performance.

On the other hand, prominent invoices, including David Swenson,<sup>238</sup> Professor Forman,<sup>239</sup> and Professor Munnell,<sup>240</sup> argue that rank-and-file employees will never be good investors. From this premise, it is a potentially valuable service for the state to provide to these employees state pension plans' professional investing skills to manage

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<sup>236</sup> *Id.* (adding § 100013 to the CAL. GOV'T CODE (2012)).

<sup>237</sup> Peter Lattman, *Ex-Chief of Calpers is Charged with Fraud*, N.Y. TIMES, March 19, 2013, at B3; Reuven Fenton and Carl Campanile, *Jailbird Hevesi is Free Out after 20 Mos.*, N.Y. POST, Dec. 13, 2012, at 8; Edward A. Zelinsky, *Public Pensions' Unrealistic Rate of Return Assumptions*, OUPBLOG (Aug. 6, 2012, 8:30AM), <http://blog.oup.com/2012/08/public-pensions-unrealistic-rate-of-return-assumptions/>; Edward A. Zelinsky, *Public Pensions, Private Equity, and the Mythical 8% Return*, OUPBLOG (March 5, 2012, 8:30AM), <http://blog.oup.com/2013/03/public-pensions-private-equity-return/>.

<sup>238</sup> DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 4 (2005) ("Even with a massive educational effort, the likelihood of producing a national of effective investors seems small.").

<sup>239</sup> Jonathan Barry Forman & Gordon D. Mackenzie, *Optimal Rules for Defined Contribution Plans: What Can We Learn from the U.S. and Australian Pension Systems*, 66 TAX LAWYER 613, 633 (2013) ("On average, individual workers tend to be pretty poor investors.").

<sup>240</sup> ALICIA H. MUNNELL, STATE AND LOCAL PENSIONS: WHAT NOW 187 (2012) ("Since employees shoulder all the risks in a 401(k) system, they have to make good decisions for tehse plans to work well. But employees make mistakes at every step along the way.").

such employees' retirement accounts.

Here again my personal preference is for state experimentation, despite my skepticism about some of the possible experiments.<sup>241</sup> A state could plausibly mandate that every private employer maintain an retirement savings arrangement for its employees (whether a qualified plan or a payroll deduction IRA program) without the state itself getting into the business of investing private employees' retirement savings.<sup>242</sup> This is the approach embodied in President Obama's proposed employer mandate, i.e., employers with more than ten employees would be required to maintain retirement plans or IRA savings programs, but there would be no public investment vehicle like the California Trust.<sup>243</sup>

The argument for investing retirement funds privately (rather than through a public entity like the Trust) is reinforced by both the DOL's recently-adopted regulations requiring fee disclosure<sup>244</sup> and soon-to-be proposed regulations heightening the fiduciary obligations of investment advisors.<sup>245</sup> If successful, these regulations should reduce the fees paid by pension plans and participants and should better align the interests of investment counselors with the interests of these plans and participants. The skeptics<sup>246</sup> could retort that, even with these desirable changes, most employees will never be good investors and thus would benefit from the investment services of CalPERS and other professionally-run state pension funds. Different states' experiments would help determine who is right.

Yet a final alternative for a legislature favoring the kind of cash

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<sup>241</sup> Edward A. Zelinsky, *State-Administered Retirement Plans for the Private Sector: A Bad Idea*, OUPBLOG (May 21, 2008, 12:55 PM), [http://blog.oup.com/2008/05/private\\_sector\\_retirement\\_plans/](http://blog.oup.com/2008/05/private_sector_retirement_plans/).

<sup>242</sup> See JONATHAN BARRY FORMAN, *MAKING AMERICA WORK* 234 (Kathleen Courrier et. al. eds., 2006) ("Employers without a retirement plan should be required to offer payroll-deduction IRAs to interested employees.").

<sup>243</sup> DEP'T OF THE TREASURY, *supra* note 5, at 125.

<sup>244</sup> 29 C.F.R. § 2550.404a-5(c) (2013). While there is substantial merit to these new regulations, the adoption of these (and other) new regulations should be offset by countervailing reductions of other, less productive regulatory burdens. Edward A. Zelinsky, *The Paternalistic Ideology of ERISA and Unforgiving Courts: Restoring Balance Through a Grand Bargain*, 26 HOFSTRA LAB. & EMP. L.J. 341, 350-53 (2009).

<sup>245</sup> Kristen Ricaurte Knebel, *Fiduciary Re-Proposal "Not Finished," Will Go To OMB Next Year, Borzi Says*, BNA PENSION & BENEFITS DAILY, Nov. 16, 2012, at 4.

<sup>246</sup> Swensen, *supra* note 237, at 4; Forman & Mackenzie, *supra* note 238, at 633; Munnell, *supra* note 239, at 187.

balance formula embodied in the Act would be to mandate that employers purchase for their otherwise uncovered employees individual retirement annuities<sup>247</sup> offered by insurance companies. State-mandated annuities are likely to meet greater popular resistance than state-mandated accounts. In our defined contribution culture, the norm for savings is today based on the account model.<sup>248</sup> But cultures change and can be changed.

A particular interesting variant of the mandatory annuity alternative is for the state requiring such annuities to charter a state-sponsored insurance company to provide annuities. A state-run company could be the exclusive purveyor of annuities for those employees participating under the state retirement savings program or the state provider of annuities could instead be a TVA-style public option, competing against private insurers. While my personal enthusiasm for this possibility is limited, a commitment to Brandeisian experimentation implies that I could be surprised.

## X. CONCLUSION

The California Secure Choice Retirement Savings Trust Act is important both because of California's size and status as a trendsetter and because the Act targets a pressing problem, the lack of retirement savings by low-income workers. The notional cash balance-style accounts created by the Act do not qualify as individual retirement accounts since the accounts authorized by the Act create a defined benefit-type, formula-based claim against a collectively-managed fund. Under the Code and ERISA, individual retirement accounts directly allocate investment gains and losses to the individual account holder.

The Act could be amended to recast its accounts as true individual retirement accounts that assign investment risk and loss directly to the account holder. If so, the Act's employer mandate and supplemental employer contributions should survive ERISA-preemption under *Travelers*. Legality does not equate with wisdom and thus the Act, along with President Obama's proposed federal mandate, should provoke debate about the need and best means to encourage greater retirement savings by the less affluent. In that debate, I favor state-by-state experimentation rather than any single approach to the task of encouraging greater retirement savings.

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<sup>247</sup> I.R.C. § 408(b) (2012).

<sup>248</sup> Zelinsky, *supra* note 66, at 31-37.