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NEW YORK STATE BAR ASSOCIATION TAX SECTION

Simplification of the Internal Revenue Code: Individual Retirement Arrangements, Qualified Retirement Plans, and Employee Benefits

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New York State Bar Association Tax Section

Simplification of the Internal Revenue Code: Individual Retirement Arrangements, Qualified Retirement Plans, and Employee Benefits*

Last March the New York State Bar Association Tax Section submitted a report on simplification of the Internal Revenue Code (the "Code"). While 2002 was not a year in which significant simplification legislation was enacted, we hope that 2003 will be different in this regard. We termed our 2002 report a "down payment" on what we hope will be a substantial contribution to efforts to simplify the U.S. income tax system. We view this report as a "second installment" and look forward to further contributions as we respond to legislative and regulatory initiatives and requests for comment that emerge during this year.

The aspects of the Code that govern employee benefit arrangements are surely among those most eligible for simplification. The benefits area contains so many disparate options, each subject to its own peculiar requirements and limitations, and is so technically obscure, that it is understood only by a small cadre of employee benefit specialists. The Staff of the Joint Committee on Taxation (the "JCT Staff") has written that the federal pension laws "are recognized as among the most complex set of rules applicable to any area of the tax law".[1] We believe this complexity is particularly problematic in an area that directly affects the average American worker.

This report sets forth some suggestions for simplifying the employee benefit provisions of the Code.[2] In presenting our recommendations, we make

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* This report was principally drafted by David Pratt. Helpful comments were received from Samuel Dimon, Michael Schler, Andrew Stumpff, and other members of the Tax Section's Executive Committee.

[1] Joint Committee on Taxation, Overview of Present-Law Tax Rules and Issues Relating to Qualified Pension Plans, JCX-16-99, March 22, 1999, reprinted in Tax Notes Today, March 23, 1999, 1999 TNT 55-12.

[2] We acknowledge the important report prepared by the New York State Bar Association, Special Committee on Pension Simplification, A Process Awry: Federal Pension Laws, reprinted in 43 Tax Notes 463 (1989). That Committee supplemented its report in 1999: New York State Bar Association, Special Committee on Pension Simplification, ERISA: A Process Still Awry, A Need to Simplify, reprinted in 83 Tax Notes 1053 (1999). This report proposes less comprehensive changes than those prior reports. Some of our recommendations (…continued)

frequent reference to portions of an earlier report by the JCT Staff addressing the same subject. In April 2001, JCT Staff issued a detailed study (the "JCT Staff Study")[3] of the federal tax system and recommendations for simplification, including numerous recommendations for simplification of the rules governing retirement benefits. In general, this report is intended to complement, reinforce, and in some cases extend or refine the points made by the JCT Staff with respect to employee benefits tax law. Throughout the report we have attempted to avoid simply duplicating the many observations made by the JCT Staff with which we concur. Accordingly, in a number of instances we simply briefly describe a particular issue and indicate our agreement with the JCT Staff's conclusions.

The report is divided into three parts. The first part describes simplification that could be achieved by rationalizing the classification scheme for employee benefit plans under the Code. The different categories of tax-favored retirement arrangements increase complexity in the pension rules, because different rules apply to each type of arrangement.

The second part of the report concentrates on the rules applicable to individual retirement accounts and to distributions from qualified plans, which are at once among the most complicated of the complicated benefit provisions and, unfortunately, among those most likely to be faced by individual taxpayers.

Finally, we present a large number of technical suggestions for simplifying the welter of rules presently applicable under the Code to qualified retirement plans, as well as some other types of employee benefit plan.

I. RATIONALIZING BENEFIT PLAN CLASSIFICATION

Currently, several different and overlapping classification systems apply to retirement plans under the Code. The substantive requirements that must be satisfied by a plan depend in part on the category or categories in which the plan falls. For example, different sets of rules apply if a plan is considered a "profit-sharing," "stock bonus" or "pension" plan. Moreover, the rules that apply to plans maintained by governmental entities are not the same as the rules that apply to plans of private employers. (Indeed, as discussed below, governmental employers may not maintain certain types of plans, such as 401(k) plans.) These

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were first suggested by the Association of Private Pension and Welfare Plans ("APPWP"), in Gridlock: Pension Law in Crisis and the Road to Simplification (Sept., 1989), reprinted in Tax Notes Today, Oct. 20, 1989, 89 TNT 213-24.

[3] Staff of the Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, JCS-3-01, April, 2001. All page references to the JCT Staff Study are to Volume II, Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System.

distinctions are a legacy of the uneven historical development of retirement plan design and regulation. Some of the classifications now appear to serve no rational purpose whatsoever, while others serve questionable ends, or ends whose value is likely far less significant than the compliance cost associated with maintaining differing regulatory schemes.[4]

Accordingly, we recommend elimination of various categories now used under the Code to distinguish various types of retirement plans. In particular, we suggest that the Code recognize only one category of "defined contribution plan," and, in addition, that the tax rules applicable to governmental plans be made congruent to those applicable to private plans.

1. Eliminate Differing Categories Applicable to Defined Contribution Plans.

Current Law. The Code currently recognizes a myriad of retirement benefit plan types. For example, under current law an employer wishing to sponsor a defined contribution plan may adopt a "profit-sharing plan" (without a 401(k) feature), a 401(k) plan (which comes in three varieties-traditional, SIMPLE or safe harbor), a "money purchase pension plan" (including a target benefit plan), or a stock bonus plan, (including an employee stock ownership plan ("ESOP"), whether leveraged or non-leveraged). If the employer adopts a defined contribution plan that is not a "qualified plan", subject to the rules of Section 401(a),[5] the employer may adopt a SEP, an employer-sponsored IRA[6] or, if it is eligible, a SIMPLE IRA.[7] Each type of plan is subject to a different set of rules, none of which are simple. Beginning in 2006, there will also be Roth 401(k) plans and Roth 403(b) plans. It is almost impossible even for a pension expert to keep all these rules straight, and to advise a client adequately as to which type of plan is best for its needs.

The basic categorization scheme for retirement plans under the Code originally included profit-sharing, stock bonus and pension plans. Essentially, profit-sharing and stock bonus plans were types of defined contribution plans, and pension plans were defined benefit plans (except that "money purchase plans," a type of defined contribution plan, were also

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[4] This point is echoed by Gene Steuerle: "Do we need both traditional IRAs and Roth IRAs, both profit-sharing and employee stock option plans, both money purchase and profit-sharing plans, both 401(k) and 403(b) plans? My feeling is that the gains from these differentiations are small, if any, and the costs of administration are almost inevitably higher than any gains." Steuerle, Why Pension Simplification is So Difficult to Achieve, Tax Notes, July 13, 1998, 253.

[5] Unless otherwise indicated, all Section references are to sections of the Code or the regulations thereunder.

[6] Section 408(c).

[7] Section 408(p).

considered "pension" plans for the Code's purposes).[8] Originally, for a plan to be a profit-sharing plan the employer could contribute only out of its annual "profits;" in a year in which an employer operated at a loss, no contribution could be made. Contributions could be made to a money purchase plan regardless of the employer's profitability, but such a plan entailed a contribution level fixed in advance and not subject to discretion. A "stock bonus plan" was a plan primarily designed to invest in employer securities. Any plan, to be qualified, had to fit within one of the foregoing categories.

In 1984 Congress eliminated the requirement that employers may contribute to profit-sharing plans only to the extent of annual profits. Since that time, there has existed no meaningful difference among the different categories of defined contribution plan. Indeed, a plan is now statutorily required to identify itself as intended to constitute either a money purchase or profit-sharing plan, as there would in many cases otherwise be no way to tell the two apart.[9] Nonetheless, the original classification system remains in place, with substantive consequences for plan compliance.[10]

<u>Recommendation</u>. We recommend that the categories of profit-sharing, stock bonus and money purchase (including target benefit) plans be eliminated and replaced with a single "defined contribution" categorization, which would simply serve to distinguish such plans from defined benefit plans.

<u>Discussion</u>. As noted above, the current classification system for retirement plans under the Code is today largely an empty historical vestige. For nearly all important purposes, there now exists only one meaningful division among qualified retirement plans: that between defined benefit and defined contribution plans. As fundamentally different types of plan, these two are, and evidently must be, subject to different sorts of rules. For example, defined benefit plans entail a need for minimum contribution requirements, in contrast to defined contribution plans. The rules for maximum deductible contributions, accrual of benefits and other requirements must be expressed differently for these two types of plan. Within the universe of defined contribution plans, however, there no longer exists a reason to distinguish among "profit-sharing," "money purchase"

[8] This taxonomy is set forth in an early regulation, Treas. Reg. Sec. 1.401-1, promulgated in 1956.

[9] Section 401(a)(27)(B).

[10] According to the U.S. Department of Labor (DOL), in 1996 there were 63,657 defined benefit plans and 632,566 defined contribution plans, 497,173 of which were profit-sharing or thrift plans. Pension Plan Bulletin, Abstract of 1996 Form 5500 Annual Reports, no. 9, winter 1999- 2000.

and "stock bonus" plans. Elimination of these classifications would clear away an appreciable amount of now pointless regulatory underbrush.[11]

2. Eliminate Section 403(b); Permit All Governmental Employers to Maintain Section 401(k) Plans.

Current Law. Tax-exempt and educational employers frequently provide retirement benefits under a tax-sheltered annuity plan pursuant to Section 403(b), a type of program that shares many, but not all, of the characteristics of qualified plans. Contributions to a tax sheltered annuity arrangement described in Section 403(b) were previously limited by the "maximum exclusion allowance," a complex limitation that applied only to 403(b) plans. Section 632(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed the maximum exclusion allowance, for years beginning after 2001. However, even after EGTRRA, there are other significant differences between 403(b) plans and qualified plans.[12] Meanwhile, most state and local governmental employers are prohibited from maintaining a 401(k) plan, subject to an exception for certain grandfathered plans.[13]

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[11] See Perun & Steuerle, ERISA at 50, ALI-ABA Course of Study Materials, Pension Policy Conference: ERISA After 25 Years, Sept./Oct. 1999 (recommending creation of a single, standard form of defined contribution plan, inasmuch as "[t]he principal remaining differences among the plans are whether the formula is fixed or discretionary, what spousal rights attach to benefits, what limit on deductible contributions should apply, and how benefits may be distributed, that is, in cash or in stock. Whether a plan formula is fixed or discretionary, the form in which benefits are distributed, etc. do not justify the current, vestigial regime of separate classification of plans as 'money purchase,' 'profit sharing,' or 'stock bonus' plans; and we accordingly recommend that all these types of plans be made subject to a single set of rules applicable to 'defined contribution qualified retirement plans.'")

[12] First, in the case of a 403(b) plan, a participant's compensation will be his or her "includible compensation", as defined in Section 403(b)(3), rather than compensation as defined in Section 415 and the regulations thereunder. Second, for purposes of Section 415, EGTRRA provides that a 403(b) plan will be treated as a defined contribution plan maintained by each employer with respect to which the participant has the control required under Section 414(b) or (c), as modified by Section 415(h). This effectively reinstates a rule that was previously contained in the regulations under the now-repealed Section 415(e). Third, the dollar limits on elective deferrals are generally the same for a 403(b) plan as for a 401(k) plan. However, Section 402(g)(7) contains special rules for certain participants in 403(b) plans that can increase the annual limit by as much as $3,000. Finally, elective contributions under a 401(k) plan are subject to a very different nondiscrimination regime from the one that applies to elective contributions under a 403(b) plan. Elective deferrals under a 401(k) plan must satisfy an "actual deferral percentage" test each year, intended to prevent deferrals by highly compensated employees from exceeding actual deferrals (expressed as a percentage of compensation) by nonhighly compensated employees by more than a specified margin. (Alternatively, a 401(k) plan may satisfy a design-based "safe harbor," predicated on the employer's providing a minimum level of nonelective or matching contributions.) Elective deferrals under a 403(b) plan, by contrast, are subject to the requirement that they be generally *available* to all employees, but the actual deferrals are not tested for discrimination.

[13] Section 401(k)(4)(B).

Recommendations. We support the Joint Committee's recommendation that all state and local governments should be permitted to maintain 401(k) plans. We recommend repeal of Section 403(b). If this is not politically possible, then we would suggest that the rules for 401(k) plans and 403(b) plans at least be harmonized, to eliminate the (seemingly arbitrary) differences that exist under current law. Specific recommendations in this latter regard are enumerated below.

Discussion. Most of the differences between the rules for 403(b) plans and those for 401(k) plans result from a perception -- once true, but no longer valid -- that 403(b) arrangements are qualitatively different from qualified plans. Section 403(b) was originally enacted in 1958 to limit tax deferral by highly paid employees of tax-exempt employers, and 403(b) arrangements were originally more like individual deferred compensation agreements than employer plans. This is no longer true: many employers, particularly those in the educational and healthcare sectors, use 403(b) plans as their primary retirement vehicle; others use them as supplemental retirement plans, much as 401(k) plans are used by large private sector employers.

Over the years, selected qualified plan rules have been extended, sometimes with variations, to 403(b) plans, which have also been subject to an expanding set of rules under Section 403(b) itself. The result is that 403(b) plans are no longer -- if they ever were -- simple, and the differences between the 401(a) rules and the 403(b) rules are an arbitrary trap for the unwary. We suggest that considerable simplification, without identifiable policy cost, could be achieved by the outright repeal of Section 403(b).

Assuming that repeal does not occur in the near future, we applaud the repeal by EGTRRA of the maximum exclusion allowance calculation. However, in our opinion, use of "includible compensation" for purposes of Section 415, a change enacted by EGTRRA, will reinstate much of the complexity saved by the repeal of the maximum exclusion allowance rules, as the determination of "includible compensation" is considerably more difficult, particularly for a part-time employee, than the determination of "Section 415 compensation", as currently defined. In particular, we recommend that, as in the case of a qualified plan (including a qualified plan maintained by an employer that is eligible to sponsor a 403(b) plan), the "compensation" used for purposes of testing compliance with the Code should be as defined in Section 415 and the regulations thereunder, rather than "includible compensation" as defined in Section 403(b)(3).

We would also suggest that room exists to conform the rules applicable to 401(k) and 403(b) plans in a number of respects. First, we recommend that a Section 403(b) plan should not be treated as a defined contribution plan maintained by each employer with respect to which the participant has the control required under Section 414(b) or (c), as modified by Section 415(h), and that this aspect of EGTRRA should be repealed. Second, we recommend repeal of the special rules for certain participants in 403(b) plans that can increase the annual limit by as much as $3,000. Finally, we believe that discrimination testing should be conformed for elective deferrals under 401(k) plans and 403(b) plans and therefore would require discrimination testing for elective deferrals under a 403(b) plan, under the same "actual deferral percentage" regime applied to 401(k) plans.

3. Repeal of Section 457.

Current Law. Like Section 403(b), Section 457 exists today as a kind of parallel regulatory scheme applicable only to deferred compensation plans of governmental employers and private tax-exempt employers. Originally the provision functioned to limit net tax losses to the government, where an unfunded deferred compensation plan was established by a tax-exempt employer. Deferral of inclusion by the employee was not offset by an associated detriment – deferral of a deduction – to the employer. Subsequent legislation (including major changes enacted by EGTRRA) have resulted in a section that permits deferral in certain cases for certain types of employers, (with substantive accrual requirements that parallel those for qualified plans), and which actually requires that certain plans be funded.

Recommendation. We believe that governmental employers should be permitted to maintain 401(k) plans, just as private employers are. If this change were made, it would allow the concomitant repeal of Section 457. Short of this, however, we support the JCT Staff's recommendation that the statutory provisions should be redrafted so that separate provisions apply to (i) plans maintained by state and local governments and (ii) plans maintained by private tax-exempt organizations.

Discussion.

EGTRRA has further reduced the differences between governmental 457 plans and governmental qualified plans. We suggest that any remaining revenue or policy justifications for the separate regime of Section 457 are outweighed by the extra compliance costs of maintaining and enforcing different rules. It would be vastly simpler, and would at this point entail little substantive change, if Section 457 were simply repealed, at least for governmental employers, and all employers permitted to maintain 401(k) plans[14]

[14] JCT Staff Study, p. 204.

II. SIMPLIFYING THE RULES FOR INDIVIDUALS: IRAs AND PLAN DISTRIBUTION REQUIREMENTS

The rules most likely to be directly faced by individual taxpayers have become, unfortunately, among the most complex, even compared with other benefit plan provisions. We focus here upon the rules that apply to individual retirement accounts, and those that govern taxation of distributions from qualified plans.

1. Individual Retirement Arrangements ("IRAs").

Current Law. A taxpayer contemplating establishing or contributing to an individual retirement arrangement currently confronts a bewildering array of options and rules. Section 219 of the Code allows an income tax deduction for contributions to an IRA. The amount of the deduction is reduced (potentially to zero) if the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan and his or her AGI is higher than a certain amount.

Alternatively, an individual may make nondeductible contributions to a traditional IRA[15] or to a Roth IRA[16]. The amount that can be contributed to a Roth IRA is also reduced (potentially to zero) if the taxpayer's modified AGI is above a certain amount.[17] Finally, an individual may roll over funds from a traditional IRA to a Roth IRA, but only if his or her AGI for the year does not exceed $100,000.[18] The amounts at which these income thresholds take effect are all different.

No contribution to a traditional IRA is allowed for the taxable year in which the taxpayer attains age 70 1/2, or any subsequent year.[19] By contrast, contributions may be made to a Roth IRA after age 70 1/2.[20]

Recommendations.

1. We agree with the JCT Staff that the income thresholds to make deductible IRA contributions, Roth IRA contributions, and conversions of

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[15] Section 408(o).

[16] Section 408A.

[17] Section 408A(c)(2), (3).

[18] Section 408A(c)(3)(B).

[19] Sections 219(d)(1), 408(o)(2).

[20] Section 408A(c)(4).

traditional IRAs to Roth IRAs should be conformed, but we note that elimination of the thresholds would extend a tax benefit to highly compensated individuals.

2. We agree with the JCT Staff that the ability to make nondeductible contributions to traditional IRAs should be eliminated.

3. We agree with the JCT Staff that the age restrictions on eligibility to make IRA contributions should be the same for all IRAs.

4. We recommend that the basis recovery rules for traditional IRAs[21] and Roth IRAs[22] be conformed.

Discussion. As the JCT Staff has noted, proposals along the lines of the foregoing would reduce the number of IRA options and would conform the eligibility criteria for IRAs, thus simplifying taxpayers' savings decisions. We believe that greater simplification could be achieved by repealing Roth IRAs but recognize that this is highly unlikely. Accordingly, we support the above proposals as the best realistic approach.

While we understand that Congress imposed income thresholds on IRAs to limit the retirement subsidy for wealthy individuals, there is no apparent policy justification for different income thresholds or age limits for different types of IRA. Therefore, we concur with the JCT Staff that the thresholds should be conformed. However, this does not imply that there should be no income threshold, particularly as EGTRRA will increase the maximum annual IRA contribution from the present level ($3,000) to $5,000 by 2008, and (for a person aged 50 or older) will allow an additional $1,000 annual catch-up contribution. Survey evidence consistently shows that the overwhelming majority of IRA contributions are made by upper income taxpayers: the income thresholds should not be removed without careful consideration of the distributional consequences.

The current basis recovery rules for non-qualified distributions from Roth IRAs are highly favorable to the taxpayer, as the entire basis can be recovered before any taxable income is received. By contrast, where a taxpayer has made nondeductible contributions to a traditional IRA, distributions are subject to the general annuity principles of Section 72, which means that only a portion of each distribution is treated as return of basis. This more harsh result is further complicated (and potentially gives rise to a trap for the unwary) as a result of Section 408(d)(2)'s requirement that for purposes of calculating return of basis, all of a taxpayer's IRAs must be aggregated, including rollover IRAs and employer-sponsored IRA arrangements (simplified employee pensions (SEPs)

[21] Section 408(d)(2).

[22] Section 408A(d)(4).

and SIMPLE IRAs). We recommend that the rules be conformed, but recognize that extending the Roth IRA rules to traditional IRAs will affect revenue.

2. Exceptions to the Early Withdrawal Tax; Half-year Conventions.

Current Law. Section 72(t) generally imposes a 10% additional income tax on distributions from retirement plans (including IRAs) that are (i) includible in gross income and (ii) made before age 59½. There are numerous exceptions, some of which apply only to qualified plans and some of which apply only to IRAs.

Elective deferrals (and certain amounts treated as elective deferrals) under a 401(k) plan or 403(b) plan, and all contributions to a 403(b) plan that is funded with mutual funds, rather than with annuity contracts, may only be distributed if one of the so-called “distribution events” enumerated in Section 401(k)(2)(B) has occurred. One distribution event is attainment of age 59½.

Recommendation. We generally support the JCT Staff’s recommendations that (i) the exceptions to the early withdrawal tax under Section 72(t) should be uniform for all tax-favored retirement plans and (ii) the applicable age requirement for the early withdrawal tax, and for permissible distributions from 401(k) and 403(b) plans, should be changed from 59 ½ to 55. Moreover, we suggest that consideration be given to more radical simplification (such as, for example, eliminating all exceptions to the early withdrawal tax other than for death and disability, or for distributions that are actually and irrevocably annuitized).

Discussion. At present, the survey evidence suggests that the Section 72(t) tax disproportionately burdens lower income taxpayers. A 10% tax is clearly not sufficient to deter premature withdrawals, and spending, of retirement savings. One approach would be to increase the tax significantly, but this would also disproportionately affect lower income plan participants, including some who have immediate needs for which they would use the money.

A better approach might be to significantly limit, or eliminate, the right to receive withdrawals from a qualified plan or 403(b) plan before a certain age, by requiring a direct rollover, to an IRA or another qualified plan, of all distributions other than annuity payments. A more radical change would extend this requirement to IRAs. Such a step would have the added benefit of making “simplified employee pensions” (“SEPs”), under Section 408(k), and “simple retirement accounts,” under Section 408(p), more appealing as employer-sponsored retirement vehicles. Both types of arrangement are intended to provide employers an easy, inexpensive way to offer tax-favored retirement benefits, but the rules applicable to both currently prevent the employer from imposing any restriction on participant withdrawals.[23]

The JCT Staff's proposals regarding Section 72(t) itself would improve the rules but arguably do not go far enough. Under Section 72(t) there are now 15 separate statutory exceptions, several of which (such as the exception for deductible medical expenses) are of very little use in practice and at least one of which (the exception for substantially equal payments) is used almost exclusively by wealthier individuals. Therefore, we recommend that consideration be given to eliminating all but the exceptions for death and disability and for distributions that are actually and irrevocably annuitized.

3. Minimum Distribution Rules.

Current Law. The Code requires retirement plan participants, IRA owners and their beneficiaries to begin receiving distributions, generally at age 70½.[24] The statute leaves most of the detail to be provided by regulations. In 1987, IRS issued complex proposed regulations, which were never finalized. On April 16, 2002, IRS issued final regulations[25] which simplify the rules considerably and will almost always reduce the amounts required to be distributed, relative to the 1987 proposed regulations.

Recommendations. We recommend an approach under which (i) a plan participant (or IRA owner) would be required to receive distributions beginning at age 70½ , based on the expected remaining life or lives of the participant (owner) and/or the spouse and (ii) subsequent beneficiaries would "step into the shoes" of the deceased for purposes of the required withdrawal schedule.

Discussion. The tax policy underlying the minimum distribution rules is that retirement funds are accumulated, and receive significant tax benefits, to provide retirement income to the employee and, if he or she is married, to the spouse. The purpose is not to allow plan participants to amass large estates to pass on to their heirs. Thus, IRS has applied an incidental death benefit test for many years, the previous estate tax exclusions have been repealed,[26] and the minimum distribution rules were extended to all qualified plans in 1986.

[23] Sections 408(k)(4) and 408(p)(3).

[24] Sections 401(a)(9), 403(a)(1), 403(b)(10), 404(a)(2), 408(a)(6), (b)(3), 457(d).

[25] 67 Fed. Reg. 18988. Previously, in January, 2001, revised proposed regulations had been issued [66 Fed. Reg. 3928], and the final regulations largely follow the 2001 proposed regulations. The final regulations are effective January 1, 2003. In determining the amount of any required minimum distribution for calendar year 2002, a taxpayer may use the final regulations, the 1987 proposed regulations or the 2001 proposed regulations.

[26] Sections 2039(c) and (f).

We believe that our recommendation furthers this policy. Where the form of benefit is an annuity, the question arises whether the annuity must be purchased from an insurance company. We suggest that this should not be required in the case of a defined benefit plan.

We believe that these recommendations represent a significant improvement over the current regulations. The final regulations issued in April, 2002, although significantly less complex than the 1987 proposed regulations they replaced, are still very difficult to work with, even for participants and beneficiaries who have access to expert advice.

4. Basis Recovery Rules for Qualified Retirement Plans and IRAs.

Current Law. Under current law, there are different basis recovery rules for qualified plans and IRAs (where participants have made nondeductible contributions), and Roth IRAs.

Recommendations. Like the JCT Staff, we believe that the basis recovery rules for qualified plans, IRAs and Roth IRAs should be conformed, but we recognize that extending the favorable Roth IRA rules to qualified plans and IRAs will provide taxpayers with an additional benefit and adversely affect revenue. We also support the JCT Staff's proposal to redraft Section 72 to improve its readability.

Discussion. Despite some recent simplifications, the calculation of the portion of each distribution that is attributable to nondeductible participant contributions, and therefore return of basis, is unnecessarily difficult, often involving the application of special grandfather rules. Also, there is no good policy reason to have different basis recovery rules for different types of retirement savings vehicle, particularly given the greatly relaxed rollover rules under EGTRRA. However, it is not clear to us whether the very favorable Roth IRA rules should be extended to qualified plans and IRAs or their less favorable rules imposed on Roth IRAs.

We agree with the JCT Staff that Section 72 be redrafted to improve readability. It is highly unsatisfactory that the primary section dealing with the taxation of retirement plan distributions also includes numerous provisions that have nothing to do with retirement plans. The Code would be much more user-friendly if all of the rules relating to taxation of retirement plan distributions were in the same part of the Code.

5. Payment of Benefits.

Current Law. Pension plans (whether defined benefit or defined contribution) generally are not allowed to make in-service distributions, unless the employee has attained normal retirement age or the plan has terminated.[27]

Profit-sharing plans, stock bonus plans and ESOPs may (with the exception of elective deferrals under a 401(k) plan and certain other amounts, such as qualified matching contributions ("QMACs"), qualified non-elective contributions ("QNECs") and safe harbor 401(k) contributions) incorporate liberal in-service distribution rules.[28]

The rules for 403(b) plans differ, depending on whether the funds are invested in annuity contracts or mutual funds.[29]

Employer contributions to a SEP may not be conditioned on any portion of the contribution being kept in the account, and the employer may not prohibit withdrawals from the SEP.[30] A similar rule applies to SIMPLE IRAs.

Recommendation. All retirement plans and IRAs should be subject to a uniform set of distribution rules.

Discussion. These distribution rules are not well understood: many people believe, incorrectly, that a distribution from a profit-sharing plan may be made at any time at all, if the plan so provides. The differences in the distribution rules, applicable to different types of plan, serve no useful purpose, and are a trap for the unwary. In addition, they fail to fulfill the goal of preserving funds for retirement, as a large proportion of pre-retirement distributions are simply spent, rather than being transferred to another retirement program, such as a rollover IRA.

It is time-consuming and inefficient to have three separate sets of rules, and the complexity of the rules for elective deferrals is particularly troubling given the ever-increasing prevalence of 401(k) plans. We recognize that Congress intended to restrict the ability of employees to use 401(k) deferrals as short-term savings arrangements but, rather than enacting special restrictions, we

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[27] Treas. Reg. Sec. 1.401-1(b)(1)(i). TIR 1403, Q & A M-15; Revenue Ruling 69-277, 1969-1 C.B. 116; Revenue Ruling 71-24, 1971-1 C.B. 114. According to Revenue Ruling 78-120, 1978-1 C.B. 117, a plan may specify that any age less than 65 is the normal retirement age.

[28] Treas. Reg. Sec. 1.401-1(b)(1)(ii); Revenue Ruling 60-323, 1960-2 C.B. 148, modifying Revenue Ruling 56-693, 1956-2 C.B. 282.

[29] Section 403(b)(7)(A)(ii).

[30] Section 408(k)(4).

believe that the better approach would be to limit access to employees' interests in all types of tax-favored retirement arrangements, including IRAs and 403(b) plans. The ultimate goal is to preserve these funds for retirement, and thus the type of the plan and the source of the original contributions are unimportant by comparison.

The inability of an employer to restrict withdrawals from a SEP or SIMPLE IRA significantly undermines their effectiveness as retirement savings arrangements.

6. Taxation of Distributions.

Current Law. In general, distributions from qualified plans and IRAs are subject to taxation as ordinary income, except to the extent that they represent a return of basis. However, if the plan distributes employer securities, there are special rules for the "net unrealized appreciation."[31] Also, in the case of a participant born before 1936, certain lump sum distributions qualify for favorable averaging or capital gains treatment. This does not apply to 403(b) plans, 457 plans or IRAs.

As discussed above, most distributions before age 59 ½ are subject to a 10% additional income tax.[32] This tax applies to 401(k) plans, 403(b) plans and IRAs, but generally not to Section 457 plans.[33]

An "eligible rollover distribution" made after 2001 from a qualified plan, 403(b) plan, IRA or governmental 457 plan may be rolled over to another such plan. Unless the distribution is directly rolled over, an eligible rollover distribution is subject to mandatory 20% income tax withholding: this does not apply to distributions from an IRA. Distributions from a private sector 457 plan are not eligible for rollover, but a direct transfer may be made from one 457 plan to another.[34]

The constructive receipt rule does not apply to qualified plans, 403(b) plans or IRAs,[35] but does apply to 457 plans. After 2001, it will not apply to governmental 457 plans.[36]

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[31] Section 402(e)(4).

[32] Section 72(t).

[33] The tax does apply to distributions, made after 2001, from a governmental 457 plan, that are attributable to amounts rolled over to that 457 plan from a qualified plan, 403(b) plan or IRA.

[34] Section 457(e)(10).

[35] Sections 402(a), 403(b)(1), 408(d)(1).

[36] Section 457(a).

Recommendation. We recommend that the special rules granting favorable tax treatment of lump sum distributions and net unrealized appreciation on employer securities should be repealed.

Discussion. The original premise for favorable tax treatment of lump sum distributions and net unrealized appreciation on employer securities was to avoid bunching of income. That premise has not been valid since rollovers were introduced in 1974. These special rules have no continuing justification and should be repealed completely.

7. Rollovers.

Current Law. Effective for distributions made after 2001, EGTRRA has greatly simplified and rationalized the rollover rules. In general, any "eligible rollover distribution" (including after-tax contributions) from any retirement plan (including a governmental 457 plan, but not a private sector 457 plan) may be rolled over to any other such plan, by the participant or owner or by a beneficiary who is a surviving spouse or (if the spouse or former spouse) the alternate payee under a qualified domestic relations order.

In general, unless there is a direct rollover, the rollover must be effected within 60 days. However, EGTRRA has given IRS discretionary authority to extend this time limit where it would be equitable to do so.

Recommendation. We recommend that the following simplifying changes should be made to the rollover rules for retirement plans:

1. Allow rollovers of any actual distributions (including annuity payments, but excluding corrective distributions and required minimum distributions).

2. Eliminate the rule that does not permit the cash equivalent of distributed property to be rolled over,[37] so that, if a qualified plan distributes property that cannot be held by an IRA (such as S corporation stock, life insurance or a collectible), the property need not be sold in order to effect a rollover.

Discussion. In recent years, increased attention has been paid to the importance of keeping assets in the retirement system, rather than having distributions be used for current consumption. Recommendation 1 furthers this objective. Recommendation 2 deals with a rollover rule that serves no useful purpose and may impede portability of retirement plan assets.

[37] Sections 402(c)(1)(C), (c)(6); Revenue Ruling 87-88, 1987-33 I.R.B. 6.

III. TECHNICAL SIMPLIFICATION

A. Qualified Retirement Plans.

1. Definition of Compensation.

Current Law. The Code provides different definitions of compensation for purposes of different requirements applicable to qualified plans. Under Section 415, as amended by EGTRRA, the maximum "annual addition" (employer contributions plus employee contributions plus forfeitures) for an employee under all qualified defined contribution plans of the employer (and certain related employers) is the lesser of $40,000 or 100% of compensation. Under qualified defined benefit plans, the maximum annual benefit is the lesser of $160,000 or 100% of the employee's average compensation over the three-year period that produces the highest average. There are three main definitions that are relevant to qualified plans:

1. Section 415 compensation, which is used to apply the Section 415 limitations on contributions and benefits;

2. Section 404 compensation, which is used to calculate the deduction allowable to the employer, for its contributions to the plan, under Section 404; and

3. Section 414(s) compensation, which is used to test whether the plan satisfies the Code's nondiscrimination rules.

Each of these definitions is also used for other purposes and, in each case, variations from the general definition are permitted. Thus, according to the JCT Staff, there are five permissible definitions of Section 415 compensation, five permissible definitions of Section 404 compensation, and 22 permissible definitions of Section 414(s) compensation[38].

There is also a special definition of compensation for SIMPLE plans.[39]

Recommendation. We generally support the JCT Staff's proposal to adopt a single definition of compensation, for purposes of applying all of the Code's various qualified plan requirements, equal to (i) the amount reportable as compensation on Form W-2, plus (ii) elective contributions, including Section 125 salary reductions. The JCT Staff went further, however, and recommended

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[38] *See* JCT Staff Study, Table 13, Definitions of Compensation for Qualified Retirement Plan Purposes.

[39] Section 408(p)(6)(A).

not merely that such a uniform definition be used for purposes of applying the requirements applicable under the Code, but that the uniform definition be required to be used *under the terms of each qualified plan* in determining the amount of benefits earned under the plan's benefit formula. We believe such a mandate would be unjustifiably restrictive and would not have a sufficiently compensating simplification benefit; accordingly, we oppose this aspect of the JCT Staff's recommendation.

Discussion. Reducing the number of alternative definitions of compensation will reduce complexity in plan design and administration, without affecting revenue or any readily identifiable public policy. This is also consistent with the policies underlying these statutory provisions, namely providing limits on the extent to which qualified plans are subsidized by the tax system[40] and requiring that contributions or benefits under qualified plans not discriminate in favor of highly compensated employees.[41] In addition, it is important to have uniformity in applying statutory requirements such as the Section 415 limitations and the nondiscrimination rules. Unlike the JCT Staff, however, we do not believe that a persuasive case exists for imposing on each qualified plan a mandatory uniform definition to be used for purposes of determining benefits. If a single definition of compensation were instituted for purposes of applying the Code's requirements, a plan sponsor would of course be free, if it chose, to adopt that same definition for purposes of the plan's benefit formula. While so choosing would likely minimize the employer's burden in demonstrating the plan's compliance, we believe the employer should have the flexibility to choose otherwise, as appropriate to reflect the peculiarities of its business. (For example, certain employers may strongly wish to distinguish, as a matter of plan design, between salary and bonus or between salary and sales commissions.) Adopting a unified definition of compensation solely for testing purposes under the Code would eliminate the inherent statutory complexity currently faced by employers, while leaving them generally free to decide how to structure retirement compensation. Any possibility of abuse would be precluded by the plan's having to demonstrate compliance with the nondiscrimination and other statutory requirements using the standardized definition.

2. Nondiscrimination Rules for Qualified Plans.

Current Law. A qualified plan must cover a minimum percentage of the employer's nonhighly compensated employees (NHCEs).[42] The minimum percentage is determined by reference to the percentage of highly compensated employees (HCEs) who benefit under the plan. The plan must satisfy one of two tests, the ratio percentage test or the average benefits test.

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[40] Sections 404 and 415.

[41] Sections 401(a)(4) and 414(s).

[42] Sections 401(a)(3), 410(b).

The basic nondiscrimination rule requires that either the contributions to, or the benefits under, the plan not discriminate in favor of HCEs.[43] This allows for "cross-testing," under which benefits under a defined benefit plan are converted into equivalent contributions or (more often) amounts allocated to employees under a defined contribution plan are converted to equivalent benefits for testing purposes.

The Treasury regulations implementing the coverage and nondiscrimination rules are technically complex, and often require detailed computations. They reflect a change to bright-line tests from the facts and circumstances approach that prevailed before enactment of the Tax Reform Act of 1986.

In applying the tests, certain employees are excluded from consideration, and two or more plans may be aggregated and treated as a single plan for testing purposes. In some cases, the regulations provide for mandatory aggregation or disaggregation.

Recommendation. The JCT Staff made three recommendations in this area.

1. We support the JCT Staff's proposal that "excludable employees" (*i.e.*, employees who do not yet satisfy minimum age and service requirements) should be disregarded in applying the minimum coverage and general nondiscrimination rules applicable to benefit plans, even if some or all of them are covered by the plan

2. We do not support the JCT Staff's proposal that the cross-testing rules applicable to benefit plans be codified. New regulations have been issued since the JCT Staff's was issued, and we believe that codification of the rules should be delayed to allow these regulations to be implemented.

3. We do not support the JCT Staff's proposal that the ratio percentage test applicable to benefit plans should be modified to allow more plans to use it because it is not clear to us why the NHCE concentration percentage has any bearing on the appropriate percentage to be used in the ratio percentage test and there is a strong argument that the current 70% threshold is too low.

4. We further recommend that the top-heavy rules applicable to benefit plans should be modified to clarify that, if excludable employees are allowed to participate, the employer is not required to provide the top-heavy

[43] Section 401(a)(4).

minimum contribution or benefit until such excludable employees have satisfied the plan's normal eligibility requirements.[44]

Discussion. We support the proposal that excludable employees should be disregarded in applying the minimum coverage and general nondiscrimination rules, even if some or all of them are covered by the plan. This would further two important goals: it would simplify plan administration, and would encourage employers to reduce or eliminate eligibility waiting periods, thus increasing plan coverage and the total benefits that the typical employee (who will have several jobs during his or her working career) will accumulate.

The JCT Staff also expressed the belief "that further simplification could be achieved by eliminating some nondiscrimination rules or making significant changes to the rules", but concluded that "such changes would involve policy ramifications that are beyond the scope of this study." [45] We agree with this assessment. The current rules are repeatedly identified as being among the most complex rules in an unusually complex area of the Code, and reduction of the level of complexity might encourage more employers, particularly smaller employers, to adopt qualified plans. However, any significant changes to these rules may cause additional complexity and disruption for existing plan sponsors.

With respect to cross-testing, the JCT Staff noted that:

> The 1986 legislative history could be read to suggest that cross-testing should apply only in the case of combined plans or average benefits testing. Moreover, to the extent that cross- testing appears to be used in some cases merely to provide better benefits to highly compensated employees, cross-testing could be considered not only complicated, but also contrary to the policy behind the nondiscrimination requirements.[46]

However, since the JCT Staff Study was published, new final cross-testing regulations have been issued[47] and, although cross-testing is now far more prevalent than in the past, the ability to cross-test has long been available.[48]

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[44] More fundamentally, we recommend below that the top-heavy rules simply be eliminated from the Code.

[45] JCT Staff Study at 183.

[46] *Id.*

[47] Treasury Decision 8954, 66 Federal Register 34535 (2001).

[48] *See, e.g.*, Revenue Ruling 81-202 (setting forth the pre- TRA 86 rules for determining plan comparability).

We believe that it would be premature to change the cross-testing rules again until there has been time to assess whether the new regulations are effective in combating abuse of the cross-testing rules.

We believe that there is a strong argument that all of the current regulations under Section 401(a)(4), not only the cross-testing rules, should be reviewed: anecdotal evidence and personal experience suggest that discrimination is in fact more widespread than it was before these regulations were adopted. However, changing such fundamental rules again, so soon after IRS issued the new cross-testing regulations, would be unduly disruptive. Accordingly, we suggest that a better approach would be for Treasury and the IRS to (i) solicit comments and recommendations for improvements to the current rules, together with information as to their effect on the formation and administration of both large and small plans, and (ii) in the light of this information, to consider whether to issue new proposed regulations. Any revisions to the regulations should include adequate time for plan sponsors to transition from the old rules to the new rules without undue disruption.

Finally, the JCT Staff recommended that, in applying the ratio percentage test, the ratio percentage would be reduced below 70% if (i) the plan covers a reasonable classification of employees, under present law rules, and (ii) the nonhighly compensated employee (NHCE) concentration percentage is at least 60%. The ratio percentage would be reduced to 65% if the NHCE concentration percentage is 60% to 79%, and to 60% if the NHCE concentration percentage is 80% or more.

We recommend that this change not be made. First, it is not clear why the NHCE concentration percentage has any bearing on the appropriate percentage to be used in the ratio percentage test. The NHCE concentration percentage focuses on the percentage of the employer's employees who are highly compensated, and can be high simply because the employer does not employ a large number of highly compensated individuals. For example, if an employer had ten highly compensated employees and 100 nonhighly compensated employees, under the JCT Staff proposal the employer could adopt a plan that covered all ten of the highly compensated employees but only 60 of the 100 nonhighly compensated employees. (In this example the NHCE concentration percentage is 100/110, or 91%, and the ratio percentage is (60/100)/(10/10), or 60%) The mere fact that the employer's workforce is characterized by a small number of highly compensated employees should not substantially increase the employer's ability to discriminate against nonhighly compensated employees.

Second, we believe there is a strong argument that even the default 70% ratio percentage threshold — though sanctioned by long usage — is too low. A plan that covers all of an employer's highly compensated employees, but only 70% of its nonhighly compensated employees, and none of its excludable employees, could easily be described as "discriminatory." In any event, relaxing these tests would raise significant policy considerations and therefore should not, we believe, be included in a set of recommendations whose focus is principally on simplification.

3. Vesting Requirements.

Current Law. A participant's employer-provided benefit under a qualified plan must vest at least as rapidly as is required by one of two alternative vesting schedules:

1. 5-year cliff vesting: no vesting until the participant has five years of service, then full vesting on completion of five years of service.

2. Graduated vesting: 20% after three years of service with an additional 20% for each subsequent year of service, resulting in 100% vesting after seven years of service.

If the plan is top-heavy, then it must provide either (i) 100% vesting after three years of service or (ii) graduated vesting, beginning at 20% after two years of service with 20% per year thereafter, resulting in 100% vesting after six years of service.

Certain years of service may be disregarded for vesting purposes, including service performed before the adoption of the plan.

Recommendations. We support the Joint Committee recommendation that the vesting requirements for all qualified plans be made uniform by applying the top-heavy vesting schedules to all plans. We note that section 633 of EGTRRA has already enacted this change for employer matching contributions, effective generally for contributions for plan years beginning after 2001, so the recommendation would essentially affect employer non-matching contributions to both defined benefit and defined contribution plans.

Discussion. It is now more widely understood than when ERISA was enacted that generous vesting has only a modest effect on the total cost of a retirement plan. Many plans, particularly 401(k) plans, already provide faster vesting than the law requires.

Survey evidence indicates that the average job tenure in the American economy is now about 4 ½ years, which is less the number of years of service needed for full vesting under three of the four minimum vesting schedules (five-year cliff, three- to seven-year graded and two- to six-year top-heavy graded). From this perspective, and in view of the fact that many plans already satisfy the top-heavy vesting rules regardless of whether they are top-heavy, the change is appropriate. The change will also simplify plan design and administration, by eliminating the need for special rules for (i) matching contributions and (ii) top-heavy years. An argument against this change would be that it removes employers' ability to customize vesting schedules with an eye to the particular turnover characteristics of their business or location. However, we believe that this benefit is in practice not large, relative to the benefits that would result from simplification.

We also suggest that this change should be accompanied by repeal (or at least further simplification) of the top-heavy rules, as discussed below.

4. SIMPLE Plans.

Current Law. SIMPLE plans were introduced by the Small Business Job Protection Act of 1996, and come in two forms: SIMPLE IRAs and SIMPLE 401(k) plans.[49] Although most of the rules are the same for both types of SIMPLE plans, there are some differences:

1. State or local government employers may adopt a SIMPLE IRA but not a SIMPLE 401(k) plan;

2. The contribution rules differ: the sponsor of a SIMPLE IRA has the option to reduce the required matching contribution;

3. The SIMPLE IRA eligibility rules are less flexible than the SIMPLE 401(k) eligibility rules; and

4. Under a SIMPLE IRA that provides for matching contributions, the Section 401(a)(17) compensation limitation does not apply. The limitation does apply to a SIMPLE IRA that provides for nonelective contributions, and also to a SIMPLE 401(k) plan.[50]

Recommendations. We support the JCT Staff's recommendation that the rules for SIMPLE IRAs and SIMPLE 401(k) plans be conformed by (i) allowing State and local government employers to adopt SIMPLE 401(k) plans, (ii) applying the same contribution rules to SIMPLE IRAs and SIMPLE 401(k) plans (by extending the option to reduce the required match to SIMPLE 401(k) plans), and (iii) applying the employee eligibility rules for SIMPLE IRAs to SIMPLE 401(k) plans. In addition, we recommend that that the contribution limitations be conformed by imposing the Section 401(a)(17) limitations on SIMPLE IRAs that provide for matching contributions. Finally, we recommend that direct transfers from a SIMPLE IRA to a qualified plan maintained by the same employer should be permitted.

Discussion. SIMPLE plans were intended to provide a less complex retirement arrangement whose availability is restricted to smaller

[49] Sections 401(k)(11), 408(p).

[50] Sections 401(a)(17), 408(p)(2)(B)(ii).

employers. The proposed changes are sensible as they simplify the rules by eliminating some unnecessary differences between the two types of SIMPLE plan.

At present, the SIMPLE IRA generally offers more advantages to an employer than the SIMPLE 401(k) plan. Nevertheless, we agree with the JCT Staff that SIMPLE 401(k) plans serve a valuable function and agree that they should not be repealed.[51]

Nevertheless, technical complexity would be reduced if the requirements of the two types of SIMPLE retirement options were conformed. We recommend that the contribution rules be conformed by extending the option to reduce the required match (which is currently available only for SIMPLE IRAs) to SIMPLE 401(k) plans rather than eliminating the option for SIMPLE IRAs because we believe this option will provide greater flexibility. We also would impose the SIMPLE IRA employee eligibility rules on SIMPLE 401(k) plans because they are easier to apply. We believe this simple application outweighs the loss of flexibility. Finally, we believe that the Section 401(a)(17) compensation limitation that is currently applicable SIMPLE 401(k) plans and SIMPLE IRAs that provide for nonelective contributions should be extended to SIMPLE IRAs that provide for matching contributions.

In 1996, only 37% of employees of companies with fewer than 100 employees participated in any retirement plan. Ultimately, we are hopeful that SIMPLE 401(k) plans and SIMPLE IRA plans could be combined into a single SIMPLE plan that would be responsive to the concerns of small employers. We urge Congress to study why smaller employers do not sponsor SIMPLE plans, and design a single plan that is responsive to their concerns.

Regardless of whether both SIMPLE 401(k) plans and SIMPLE IRAs are ultimately retained, it should be made easier for employers to transition from these plans to a qualified plan. One way of assisting this would be to allow direct transfers from a simplified employee pension plan (a "SEP") or SIMPLE IRA to a qualified plan maintained by the same employer.

5. Definitions of Highly Compensated Employee and Owner.

<u>Current Law</u>. Section 414(q) defines the term "highly compensated employee," which is primarily used in testing whether a plan satisfies the employee coverage and nondiscrimination requirements, including the special nondiscrimination tests (the actual deferral percentage and actual

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[51] JCT Staff Study at 187 ("For employers who intend to adopt a SIMPLE plan only on a temporary basis and eventually to adopt a regular qualified retirement plan, the ability to adopt a SIMPLE 401(k) plan may provide greater simplification in the long term by making easier the transition from a SIMPLE plan to a regular 401(k) plan.")

contribution percentage) tests for 401(k) plans. Other employee benefit nondiscrimination tests use slightly different terms which are defined differently (e.g., Sections 105(h)(5) and 125(e)).

Another term, "key employee," again defined differently, is used primarily in determining whether a plan is top-heavy, and is also used in testing whether a cafeteria plan or a group term life insurance program is discriminatory.[52] The top-heavy rules of Section 416, similar to the Code's nondiscrimination requirements, are intended to prevent the use of qualified plans as vehicles for delivering tax benefits primarily to highly paid or owner-employees. The top-heavy rules impose minimum vesting and benefit requirements where too great a proportion of the accrued benefits under a plan are attributable to key employees. Other employee benefits rules hinge on whether an individual is a 5% owner,[53] or an owner-employee (as defined in Section 401(c)(3)).

Recommendation. We support the JCT Staff's proposals to develop uniform definitions for all qualified plan purposes by repealing all of the owner-related terms and definitions, other than (i) the 5% owner status, which would continue to be relevant for purposes of any special rules applying to owners, and (ii) the 1% owner status, which would be relevant for top-heavy purposes.[54]

We also support the JCT Staff's recommendation to adopt the Section 414(q) definition of highly compensated employee for purposes of all of the nondiscrimination requirements and repeal the other terms and definitions for highly compensated status. Finally, we recommend that if the top-heavy plan rules (Section 416) are retained, all references to "key employees", as defined in Section 416(i), should be replaced by references to highly compensated employees as defined in Section 414(q).

Discussion. There is no good reason why different definitions should apply for different purposes relating to employee benefits: the existing differences are attributable primarily to the fact that different rules were enacted separately, in different statutes. The changes recommended by the JCT Staff would greatly simplify plan administration, by allowing employers to use a single definition for several purposes, without identifiable revenue or policy effects and without, in our opinion, reducing employer flexibility or participant security in any significant way.

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[52] Sections 125(b)(2), 79(d).

[53] *See, e.g.,* sections 401(a)(9), 127(b)(3), 129(d)(4).

[54] This recommendation assumes the top-heavy rules are retained in the Code, we recommend their outright repeal below.

With respect to top-heavy plans, our preference would be to repeal the top-heavy rules completely, as they cause considerable additional complexity, both in the law and in plan administration, while conferring little additional benefit on plan participants.[55] For most employers, the key employee group and the highly compensated employee group overlap considerably, but are not identical, and the need to identify the members of the two separate groups causes considerable complexity for no good reason. Accordingly, in the absence of repeal, elimination of the separate category of key employees would achieve significant simplification.

6. Attribution Rules.

Current Law. Under the qualified plan rules, different ownership attribution rules apply for different purposes. For example, the Section 1563 rules are used in determining which employers are part of the same "controlled group" (and therefore must be aggregated for purposes of the nondiscrimination and certain other rules), but the Section 318 rules are used to determine whether someone is a 5% owner under the top-heavy rules.

Recommendation. We support the JCT Staff's proposals that (i) the attribution rules used in determining controlled group status under Section 1563 should be used in determining ownership for all qualified plan purposes, and (ii) a uniform definition of family members be used to apply ownership attribution rules for all purposes, including the qualified plan rules.

Discussion. Implementation of the proposal would simplify plan administration. Each set of attribution rules is inherently difficult to apply. Implementation of the proposal would enable an employer to perform a single ownership analysis for all qualified plan purposes.

7. The Pre-Termination Benefit Restrictions.

Current Law. Pre-ERISA rulings limited the benefits that could be paid to any of the 25 highest paid employees prior to plan termination. The current restrictions are contained in Section 1.401(a)(4)- 5(b) of the regulations.

Recommendation. We recommend that the pre-termination benefit restrictions should be repealed or their application limited to defined benefit plans that are subject to Section 401(a)(4) but are not covered by the PBGC insurance program.

Discussion. As a result of the enactment of Title IV of ERISA, and its amendment by the Single Employer Pension Plans Amendment Act of 1980, the ability of an employer to terminate a defined benefit plan has been

[55] For further discussion of this point, see "III.13 Top-Heavy Plans," below.

severely restricted. In addition, the types of employer at which the rule was directed have largely abandoned defined benefit plans. The benefit restrictions should be repealed or their application limited to the narrow class of defined benefit plans that are subject to Section 401(a)(4) but are not covered by the PBGC insurance program, such as plans of professional service employers with fewer than 25 participants.

8. The Nondiscrimination Regulations under Section 401(a)(4).

Current Law. Section 401(a)(4) contains the basic nondiscrimination rule for qualified plans. The regulations under Section 401(a)(4) are very complex, and deal with (i) nondiscrimination in the amount of contributions or benefits, (ii) the nondiscriminatory availability of benefits, rights and features under the plan and (iii) nondiscrimination in special situations, such as plan amendments.

Recommendation. We recommend simplification of the Section 401(a)(4) nondiscrimination regulations. In order to avoid unnecessary disruption to plan operations, plans should be given ample time to be brought into compliance with any changes.

Discussion. The regulations have been widely, and correctly, criticized for their technical complexity. It is not clear why it was thought necessary or appropriate to replace the prior facts-and-circumstances approach, which we believe had served adequately for many years. The regulations also fail, in at least some cases, to achieve their intended purpose of establishing bright line rules. Furthermore, the complex numerical test actually legalizes discrimination against rank-and-file workers to a greater extent than almost any benefits professional previously would have deemed possible.[56]

Most commentators agree that a major factor in the decline of defined benefit plans has been the complexity of the federal pension laws and regulations, particularly those governing defined benefit plans.[57]

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[56] Douglas W. Ell, Fallacies and Structural Flaws of Complex Numerical Nondiscrimination Testing, Tax Notes Today, April 5, 1993, 93 TNT 75-88.

[57] *See e.g.* ERISA Advisory Council, Report of the Working Group Studying the Trend in the Defined Benefit Market to Hybrid Plans, Nov. 10. 1999, available at the DOL web site, www.dol.gov, at 25-26 (Testimony of Judith F. Mazo of The Segal Company) ("The advantages of defined benefit plans have been eroded in recent years by regulatory changes. Design flexibility has been hampered by: overly detailed non-discrimination and coverage rules, lower limits on benefits, the cap on includible compensation, the minimum participation rule, separate line of business rules and other controls, rigid anti-cutback rules that prevent plan streamlining, technicalities on early retirement, actuarial equivalence, incidental death benefit rules and related subsidiary standards, court interventions and overzealous funding constraints. Deterrents to conservative funding--including the excise tax on nondeductible contributions and the current liability minimum funding cap--undermine the usefulness of pension plans as long-term retirement programs. The problem is not only the regulations themselves, but the constantly changing (…continued)

At the same time, Treasury and the IRS should consider whether the permitted disparity rules, (which permit taking social security benefits into account) in discrimination testing)[58] are worth salvaging: the theoretical underpinnings of integration have always been shaky at best, and in their present form, particularly when applied to defined benefit plans, the rules may be more trouble than they are worth.

9. Cash Balance Plans.

<u>Current Law</u>. Under the Code, a defined benefit plan is any plan which is not a defined contribution plan.[59] This covers a very wide range of possible plan designs. There are no statutory provisions that specifically deal with non-traditional or hybrid plan designs, such as cash balance plans. Recent proposed regulations address age discrimination issues presented by cash balance plans.[60] It is also our impression that Treasury and the IRS are interested in considering other issues related to cash balance plans.

<u>Recommendation</u>. We recommend that Treasury and the IRS continue to review the existing regulatory provisions governing the design and operation of defined benefit plans and determine whether and how they should be modified to address non-traditional defined benefit plan designs. The Joint Committee on Taxation may also wish to direct its Staff to study what, if any, revisions to the statutory provisions governing defined benefit plans should be considered in this regard.

<u>Discussion</u>. The litigation and other controversy resulting from the increased use of cash balance plans points to a basic problem: many of the basic ERISA concepts, like the "accrued benefit" and anti-backloading rules, work adequately for traditional defined benefit plans, but may be problematic for non-traditional plans like cash balance plans.

(continued…)

rules."); *see also* Retirement Income Security, American Academy of Actuaries Public Policy Monograph, 1998 No. 1, at 2.

[58] Section 401(l).

[59] Section 414(j). *Cf.* ERISA section 3(35). A defined contribution plan is "a plan which provides for an individual account for each participant and for benefits based solely on 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." Section 414(i).

[60] 67 F.R. 76123 (December 11, 2002) (notice of proposed rulemaking relating to age discrimination requirements applicable to certain retirement plans under Sections 411(b)(1)(H) and 411(b)(2)).

We agree with the ERISA Advisory Council that "technical provisions in current law that were specifically designed for annuity-based defined benefit plans should be examined carefully and, to the extent that it is demonstrated that they inhibit plan provisions that would provide equitable, broad-based retirement income through account-based defined benefit plans, revised as they apply to such plans."[61]

10. Interest Rates for Defined Benefit Plans.

Current Law. For purposes of determining a defined benefit plan's current liability, and in determining a plan's required contribution under Section 412(l) (additional funding requirements for single employer plans), the interest rate must be within the permissible range. The permissible range is 90% to 105% of the weighted average of the rates of interest on 30 year Treasury securities during the 4 year period ending on the last day of the previous plan year.[62] The Treasury Secretary may reduce the lower end of the range from 90% to 80%, if he finds that the lowest permissible rate is unreasonably high. In March, 2002, Congress enacted a short-term fix: in calculating the deficit reduction contribution for the 2002 and 2003 plan years, the upper end of the range has been increased from 105% to120% of the 4 year weighted average interest rate.[63]

The 30 year Treasury interest rate must also be used (i) in calculating minimum lump-sum benefits,[64] (ii) in calculating maximum benefits under Section 415,[65] and (iii) in determining the amount (if any) of the PBGC variable premium. Again, Congress has granted relief for plan years beginning in 2002 and 2003: the plan can use 100% of the rate rather than 85%.[66]

Recommendation. We recommend that the thirty- year Treasury interest rate used under current law for purposes of determining a defined benefit plan's current liability and its required contribution be replaced with a more appropriate rate.

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[61] ERISA Advisory Council, Report/ Recommendations of the Working Group Studying the Trend in the Defined Benefit Market to Hybrid Plans, November 10, 1999.

[62] Section 412(b)(5)(B).

[63] Code section 412(l)(7)(C)(i)(III), added by section 405(a)(1) of the Job Creation and Worker Assistance Act of 2002 ("JCWAA").

[64] Section 417(e)(3).

[65] Section 415(b)(2)(E)(ii).

[66] ERISA section 4006(a)(3)(E)(iii)(IV), added by section 405(c) of JCWAA.

Discussion. As the Groom Law Group has pointed out:

> The United States Treasury has been shrinking the supply of 30-year bonds. As a result, these bonds have become relatively scarce, and conservative investors have bid up the price (and decreased the yield) of these bonds. This has produced an artificially low rate of interest on 30-year Treasuries relative to both the rate of interest on long-term corporate bonds and the rate of interest inherent in the pricing of insurance company annuity contracts. For February 2001, PBGC's annuity rates started at 6.5%. But this was more than 100 basis points higher than the 30-year Treasury rates published for the very same month. That difference is material. A one-percent swing in discount rates can translate to a 10-percent or larger swing in the measured values of a plan's liabilities. A difference of that magnitude is troubling. It means that plan contributions and premiums are now being priced using a liability measure that substantially exceeds PBGC's estimate of what a private insurer would charge to take the same liabilities. It also means that participants can draw substantially more than the present economic value of their accrued benefit simply by taking a lump-sum distribution rather than an annuity form of payment. With studies showing that most workers spend rather than save their lump-sum distributions, policy makers should question whether this incentive is good pension policy.[67]

The sponsor of a defined benefit plan may need three different funding calculations: one for determining the minimum funding obligation under Section 412; one for determining whether it is liable for variable PBGC premiums; and a third to calculate its pension expense for financial accounting purposes under FAS 87. This should not be necessary.

11. Minimum Funding Rules.

Current Law. Profit-sharing plans, 401(k) plans, stock bonus plans and ESOPs are generally not subject to any minimum funding rules.[68] By contrast, money purchase pension plans (including target benefit plans) are subject to the minimum funding rules.[69]

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[67] Groom Law Group, The Case for Dropping 30-Year Treasury Rates as the Benchmark for Valuing Liabilities in Defined Benefit Pension Plans, www.groom.com; see also American Academy of Actuaries, The Impact of Inordinately Low 30-Year Treasuries on Defined Benefit Plans (July, 2001), available at www.actuary.org.

[68] If a cash or deferred arrangement is part of a pre-ERISA money purchase plan, or if an ESOP includes a money purchase plan, then the money purchase portion is subject to the minimum funding requirements.

[69] Section 412; ERISA section 302.

Recommendation. We have recommended above that the category "money purchase plan" be eliminated and subsumed within the single, simple classification "defined contribution plan." If this suggestion is not adopted, we recommend that the minimum funding requirements should in any event apply only to defined benefit plans, and not to money purchase plans.

Discussion. Consider the following plan designs:

1. A plan provides that the employer will contribute 5% of compensation for each eligible participant. The plan states that it is a money purchase pension plan.

2. The plan provides that the employer will contribute 5% of compensation for each eligible participant. The plan states that it is a profit-sharing plan.

3. The plan provides that the employer will contribute 50% of elective deferrals for each eligible participant who made deferrals during the year. The plan states that it is a profit- sharing plan that includes a cash-or-deferred arrangement ("CODA").

In each case, the employer has made a contractual commitment to contribute to the plan, that commitment is not contingent upon profits and, if the employer fails to honor its commitment, the eligible participants can sue under ERISA, or request the DOL to sue on their behalf, to enforce the plan provisions. In the first case, if the employer fails to contribute the amount specified, the employer has also violated the minimum funding requirements, and is liable for an excise tax equal to 10% of the shortfall. The profit-sharing plan and 401(k) plan described in 2 and 3 above are not subject to the minimum funding standards, so an employer which fails to make the contributions described in the plan incurs no excise tax liability.

We believe that there is no significant distinction between these three cases. The increased deduction limits for profit-sharing and 401(k) plans, under EGTRRA, are likely to result in a substantial reduction in the number of active money purchase plans; those that continue should not be subject to the minimum funding rules.

12. Discrimination Rules for Elective Deferrals.

Current Law.

1. Elective deferrals under a 403(b) plan, unlike elective deferrals under a 401(k) plan, must generally be made available to all employees, with limited exceptions.[70]

[70] Section 403(b)(12)(A)(ii).

2. Elective deferrals under a 403(b) plan are not subject to any discrimination test similar to the ADP test for elective deferrals under a 401(k) plan.[71]

3. Certain 403(b) plan participants are allowed a higher dollar limit on elective deferrals than 401(k) plan participants or other 403(b) plan participants.[72]

Recommendation. If 403(b) plans are retained, then the elective deferral rules should be harmonized with those applicable to 401(k) plans.

Discussion. The JCT Staff suggested that "further simplification could be achieved by conforming all the rules for the various elective deferral arrangements available to all employers."

The universal availability rule (see 1, above) should be replaced by the 401(k) plan eligibility rules. At the very least, the scope of some of the exceptions to the rule is unclear, and further guidance would be helpful.

Second, assuming Section 403(b) is not repealed, elective deferrals under a 403(b) plan should be subject to a nondiscrimination test similar to the "actual deferral percentage ("ADP")[73] test for 401(k) plans. Why should a tax-exempt employer that sponsors a 403(b) plan be treated more favorably than a taxable employer, or a tax-exempt employer, that sponsors a 401(k) plan? Extension of the ADP test to 403(b) plans may significantly reduce the amount of deferrals available to faculty members of law schools and medical schools, and physicians and executives employed by hospitals, but this result would not seem objectionable from a policy viewpoint.

There is an argument that the ADP test would prove burdensome for small tax-exempt entities, but it would be no more burdensome than for small businesses. And, in either case, the burden can be mitigated if the employer adopts a safe harbor plan or a SIMPLE plan. Under current law, a tax-exempt employer need concern itself with discrimination testing only if it has at least one employee who earned more than $85,000 during the preceding year. While this is not an exorbitant salary, it is hard to argue that a tax-exempt organization which can afford a salary at this level is entitled to more solicitude than a small business, especially since many small business owners earn substantially less than this amount.

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[71] Section 403(b)(12)(A)(ii).

[72] Section 402(g)(7).

[73] Section 401(k)(3).

13. Top-Heavy Plans.

<u>Current Law</u>. If more than 60% of the accumulated benefits under a plan are provided for "key employees," then the plan is considered "top-heavy" and must provide accelerated vesting and minimum contributions or benefits.[74]

<u>Recommendation</u>. The top-heavy rules should be repealed. Although the top-heavy rules help to ensure that rank-and-file employees receive at least minimal benefits under a qualified plan, the differences between these rules and the normal plan qualification rules are much less significant than when the top-heavy rules were enacted in 1982. Therefore we do not believe that repealing the top-heavy rules will significantly affect existing policies.

<u>Discussion</u>. The top-heavy plan rules were added by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). The original purpose was to ensure that rank and file employees received at least minimal benefits under a qualified plan, and to achieve that purpose new Section 416 imposed additional requirements on top-heavy plans: (1) minimum contributions (under a defined contribution plan) or benefits (under a defined benefit plan); (2) accelerated vesting; and (3) lower combined limitations for a person who benefits under both a defined contribution plan and a defined benefit plan of the same employer (or related employers).

In a report published in 2000,[75] the General Accounting Office (GAO) concluded that, in certain cases, the top-heavy plan rules require greater benefits to be provided to non-key employees than would be required by the other nondiscrimination rules. The GAO report also concluded, contrary to the experience of most pension practitioners, that the top-heavy rules impose only slight additional burdens on plan sponsors. The report concluded that

> In evaluating the top-heavy rules' impact, the federal government must weigh the extent to which the rules may in fact discourage pension coverage against the higher benefit levels and faster vesting schedules the top-heavy rules have brought about for certain workers, a task made difficult by the lack of quantifiable information.[76]

We think that the GAO report understates the regulatory burden on all qualified plans resulting from the retention of top-heavy rules, which actually

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[74] Section 416.

[75] Private Pensions: "Top-Heavy" Rules for Owner-Dominated Plans, GAO/HEHS-00-141, August, 2000, reprinted in Tax Notes Today, 2000 TNT 193-16.

[76] <u>Id</u>, paragraph 50.

affect only a small number of plans, almost all of which are very small.[77] We think that the better view is stated in a 1998 report issued by a working group of the ERISA Advisory Council,[78] which recommended repeal of the top-heavy rules:

> The top-heavy rules under Internal Revenue Code Section 416 should be repealed. They no longer provide significant protections to rank and file employees. Their effect is largely duplicated by other rules enacted subsequently. Despite their limited utility, all employers must test for top-heaviness. Since most small employers are not capable of performing these tests on their own, they represent an additional and largely unnecessary cost of maintaining a qualified retirement plan. They also create a perception within the small business community that pension laws target small businesses for potential abuses. This too discourages small business from establishing qualified retirement plans for their employees.

If and to the extent that the general coverage and nondiscrimination regulations under Sections 401(a)(4) and 410(b) are thought to be, without the backstop of the top-heavy rules, inadequate to prevent abuses, then we consider that the better approach is to tighten those rules, not to retain the top-heavy rules.

Considerable simplification could be achieved by repealing the top-heavy rules. The differences between these rules and the normal plan qualification rules are much less significant than when the top heavy rules were enacted in 1982. Legislation enacted and regulations promulgated since 1982 have imposed new requirements on all qualified plans, including those that are not top-heavy. Thus, for instance, (i) it is no longer possible (as it was in 1982) for a qualified plan to provide no benefits to participants who earn less than the Social Security taxable wage base, (ii) the cross-testing regulations generally require contributions for non-highly compensated employees that are larger than those required by the top-heavy rules, (iii) all plans are required to provide significantly faster vesting than was required in 1982 (and we have supported above the JCT

[77] According to the GAO, approximately 84% of all top-heavy plans established in 1996, the most recent year for which data were available, had fewer than 10 participants. "While 52 percent of plans with 2 to 9 participants reported being top-heavy, the proportion dropped to 14 percent of plans with 10 to 24 participants, 5 percent of plans with 25 to 49 participants, and 3 percent in the 50- to 99- participant range. Only 2 percent of plans with 100 or more participants reported top-heavy status." [Id, paragraph 32].

[78] ERISA Advisory Council, Advisory Council on Employee Welfare and Benefit Plans, Report of the Working Group on Small Business: How to Enhance and Encourage the Establishment of Pension Plans, Nov. 13, 1998, available at www.dol.gov/dol/pwba/public/adcoun/smrpt1.htm.

Staff's recommendation that all plans be made subject to the top-heavy vesting requirements) and (iv) the combined plan limitations have been repealed. We believe that any remaining slight benefits to some participants of the top-heavy rules do not justify the complexity they cause.

The top-heavy rules were simplified by section 613 of EGTRRA. Assuming that the top-heavy rules are not repealed, further changes are still required. First, the definition of the top-heavy minimum contribution should be modified by (i) making it identical to the nonelective contribution under a safe harbor 401(k) plan, and (ii) repealing the rule that elective deferrals are included in calculating the highest contribution rate for any key employee. For the same reason, repeal of the top-heavy provisions would have negligible policy impact. We note that the argument for repealing the top-heavy rules would be even more compelling if the general vesting proposal advanced above — applying the current top-heavy vesting requirements to all plans — were adopted.

Second, as suggested above, considerable simplification would result from replacing references to key employees and non-key employees with references to HCEs and NHCEs.

14. Incidental Benefits.

Current Law. Under the pre-ERISA regulations, profit-sharing plans may provide "incidental" life and health insurance benefits.[79] Pension plans may provide "incidental" life insurance protection, and may also provide health insurance for retirees (and their spouses and dependents), but not for active employees.[80] Second-to-die life insurance is permitted in a profit-sharing plan,[81] but the IRS has ruled that a pension plan which permits a participant to invest a portion of his or her account in a life insurance policy on the life of another person will not qualify.[82]

Recommendation. We recommend that, subject to transition rules, plans should be prohibited from providing incidental health and death benefits. Alternatively, if such benefits continue to be permitted, the rules should be uniform for all types of qualified plans.

Discussion. There does not appear to be any good reason for the differences summarized above. Moreover, no policy is advanced by including

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[79] Treas. Reg. Sec. 1.401-1(b)(1)(ii).

[80] Section 401(h); Treas. Reg. Sec. 1.401-1(b)(1)(i), - 14(c)(1).

[81] PLR 8445095; Treas. Reg. Sec. 1.401-1(b)(1)(ii).

[82] Revenue Ruling 69-523, 1969-2 C.B. 90.

ancillary benefits unrelated to the primary purpose of the plan – providing retirement income.[83]

Recently, some commentators have pointed out potential advantages of providing elective long-term disability coverage under a 401(k) plan. We believe that a better approach, from a long-term policy perspective, would be to rationalize the cafeteria plan rules under section 125, and harmonize them with the 401(k) plan rules, to enable this option to be made available more effectively under a cafeteria plan.

15. Special Rules for Owner-Employees.

Current Law. Before the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), plans covering "owner-employees" and other self-employed individuals were subject to significantly more restrictive rules than other plans.[84] Since TEFRA, most of the differences have been eliminated, but several distinctions remain. After EGTRRA, the remaining differences are as follows:

1. Contributions made on behalf of an owner-employee may be made only with respect to earned income derived from the trade or business with respect to which the plan is established.[85]

2. The definition of "earned income" of a self-employed individual does not correspond precisely to the "compensation" used for employees.[86]

3. For a self-employed individual, separation from service is not a triggering event for lump sum distribution treatment, but disability is. For an employee, the reverse is true.[87]

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[83] "It appears that fewer qualified plans now buy life insurance than in the past. The Department of Labor frequently has expressed its concerns about defined contribution plans investing in cash value insurance. Few plans have ever provided health insurance. Accordingly, we suggest that the rules allowing plans to provide incidental benefits be repealed. This would eliminate some complexity and would further the goal of uniform rules for all retirement plans, because IRAs are not allowed to provide these incidental benefits. These benefits can be provided easily under a separate welfare plan that is not subject to all of the complex pension rules." Pratt and Bennett, Simplifying Retirement Plan Distributions, 57 N.Y.U. Inst. on Federal Taxation, Employee Benefits and Executive Compensation, chapter 5 (1999).

[84] The term "owner-employee" is defined to include sole proprietors, more than 10% partners (this includes members of an LLC that has elected to be taxed as a partnership), and more than 5% S corporation shareholders. Section 401(c)(3).

[85] Section 401(d).

[86] Section 401(c)(2)(A).

[87] Section 401(c)(2)(A).

4. Deductible contributions on behalf of a self-employed individual are limited to his or her earned income derived from the trade or business with respect to which the plan is established, and may not be used to buy insurance.[88]

Recommendation. These few remaining differences in treatment between owner-employees and employees should be repealed. If the definition of "owner-employee" retains any significance, it should be simplified. One possible approach would be to replace all references to "owner-employees" with references to 5% owners.

Discussion. There is no policy reason for these remaining distinctions, and their elimination has become more important because of the increasing popularity of limited liability companies ("LLCs").

16. Permissible Investments.

Current Law. As a general rule, a qualified plan has a very broad range of permissible investments, subject to the following limitations:

1. The plan and its fiduciaries must comply with the prudence and diversification rules, and with any limitations imposed by the plan documents, and must avoid engaging in any "prohibited transaction."[89]

2. There are limitations on the acquisition and holding of employer securities and employer real property.[90] A defined benefit plan or money purchase plan (unless it is part of an ESOP) must generally limit investment in qualifying employer securities and qualifying employer real property to 10% of its assets. A profit-sharing plan is an "eligible individual account plan" which can, if the plan so permits, and subject to ERISA fiduciary rules, invest up to 100% of its assets therein.

3. The amount invested in life insurance contracts must be limited, so that the death benefit remains "incidental."[91]

4. Acquisition of a collectible by an individually directed account is treated as a taxable distribution.[92]

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[88] Sections 404(a)(8), (e).

[89] ERISA sections 404(a)(1)(B), (C), (D), 406; Section 4975.

[90] ERISA section 407.

[91] Treas. Reg. Sec. 1.401-1(b)(1)(i), (ii)

[92] Section 408(m).

The investments available to a 403(b) plan are much more limited: unless the employer is a church, the plan may invest only in annuity contracts issued by an insurance company or in regulated investment company stock (mutual funds).[93] However, if the plan is a defined contribution program (or a grandfathered defined benefit arrangement), and the employer is a church, or a convention or association of churches, including a church-controlled organization, the employer may maintain a retirement income account,[94] which has all of the investment alternatives available to a qualified plan and, if it is exempt from ERISA (as most church plans are), will not be subject to the ERISA restrictions. It would, however, be subject to any restrictions imposed by state law.

A SEP or SIMPLE IRA has a much broader range of permissible investments than a 403(b) plan, but is subject to the investment restrictions that apply to all IRAs (*e.g.*, no life insurance and no loans to the IRA owner), and acquisition of a collectible is treated as a taxable distribution.[95] An IRA must also limit investment in qualifying employer securities and qualifying employer real property to 10% of its assets.

There are no explicit investment restrictions for 457 plans. If the plan is exempt from ERISA, then it will be subject to any limitations imposed by state law.

Recommendation. We have recommended above that Section 403(b) plans be eliminated. If 403(b) plans are retained, we recommend that such plans be permitted to invest in the same range of assets that are available to a qualified plan.

Discussion. If 403(b) plans are retained, there appears to be no reason why 403(b)plans should have fewer investment options than qualified plans, and the existing restrictions should be repealed. Undoubtedly, many sponsors of 403(b) plans will, like many 401(k) plan sponsors, continue to invest with insurance companies and mutual fund families, but they should have the opportunity to use other investment managers.

17. Annuity Rules.

Current Law. A defined benefit or money purchase plan is always subject to the qualified joint and survivor annuity ("QJSA") and qualified preretirement survivor annuity ("QPSA") rules.[96] A profit-sharing plan, stock

[93] Sections 403(b)(1), (7).

[94] Section 403(b)(9).

[95] Section 408(m).

[96] Sections 401(a)(11), 417; ERISA section 205.

bonus plan or ESOP can escape these rules if the participant's spouse receives 100% of the account balance on the participant's death, or consents to another beneficiary.

The annuity rules do not apply to any IRA (including an employer-sponsored IRA) and a married IRA owner is not required to name his or her spouse as beneficiary of 100% of the account balance on the owner's death, or to obtain the spouse's consent to another beneficiary.

Recommendation. We recommend that all defined contribution pension plans that comply with the conditions applicable to profit-sharing and stock bonus plans should be exempt from the qualified joint and survivor annuity and qualified preretirement survivor annuity rules. In addition, although it would not necessarily further simplification, these rules should be extended to IRAs.

Discussion. The annuity rules are very difficult and costly for plan sponsors. In addition, it is almost impossible in many cases to explain effectively to employees what their choices are, and for plan participants and their spouses to decide, with any confidence, what form of distribution is best for them. Almost all defined contribution plans and many defined benefit plans allow participants to choose a lump sum distribution, and the survey evidence shows clearly that, where a lump sum is available, only a very small percentage of plan participants will choose to receive an annuity. There must be some spouses who receive a benefit because of the rules, and who would not receive any benefit otherwise. However, experience and the available evidence suggest that they are very few in number, and that this result simply does not justify the enormous expense and complexity that the rules create:

> Several empirical studies show that, unless the spouses' property is large enough to entail tax planning, spouses overwhelmingly strain to leave everything to the surviving spouse, commonly disinheriting children in the process.[97]

It is not always clear whether a 403(b) plan is subject to the annuity rules. If the plan is exempt from ERISA, as a governmental plan or church plan,[98] or pursuant to the regulatory exemption for employee-funded plans, then the statutory annuity requirements do not apply. Also if, as is relatively rare, the 403(b) plan document specifies that the plan is a profit-sharing plan rather than a pension plan, the plan can escape the rules if the participant's spouse receives 100% of the account balance on the participant's death, or consents to

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[97] Langbein & Wolk, Pension and Employee Benefit Law, Foundation Press, 2nd ed. 1995, at 553, citing empirical literature collected in Uniform Probate Code section 2-102, Comment (1993 revision).

[98] ERISA section 4(b).

another beneficiary. However, even if the plan is not subject to the annuity rules, many 403(b) plan documents, particularly those drafted by insurance companies, provide for annuities anyway.

As a first step, the law should be changed so that defined contribution pension plans that comply with the conditions applicable to profit-sharing and stock bonus plans are exempt from the QJSA and QPSA rules. The spouse would still be protected by the requirement that he or she must be the beneficiary of 100% of the participant's benefits under the plan, upon the participant's death, unless he or she consents to another beneficiary being named.

In addition, it is anomalous that spouses are protected with respect to benefits under qualified plans and 403(b) plans, but have no protection under a SEP or SIMPLE IRA, or once benefits are rolled over to an IRA, especially in light of the increasing utilization of rollover IRAs. Surely the nature and extent of spousal protection should be the same, regardless of the type of retirement arrangement involved. Accordingly, although it would not necessarily further simplification, IRAs should be subject to the same (modified) rules as apply to defined contribution plans.

18. Plans That Hold Employer Securities.[99]

Current Law. The complexity of the rules relating to employer securities is exacerbated by the fact that different sets of rules apply to different groups of plans.

(a) Rules applicable only to ESOPs, as defined in Section 4975(e)(7).

This set of rules includes the special deduction limit for leveraged ESOPs;[100] non-recognition of capital gain on certain sales to an ESOP;[101] the excise taxes for early disposition of, and for violating the non-allocation rules under Section 409(n) relating to, stock acquired by the ESOP in a transaction subject to Section 1042; the exemption from the excise tax on reversions for

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[99] As a result of the Enron debacle, new legislation may further restrict the ability of a retirement plan to invest in employer securities. For background, see Patrick J. Purcell, Congressional Research Service, Report for Congress, Employer Stock in Retirement Plans: Bills in the 107th Congress, Updated Match 28, 2002; American Society of Pension Actuaries, Comparison of House and Senate Enron Pension Bills, Updated July 12, 2002, www.aspa.org; Joint Committee on Taxation, Background Information on Investment of Retirement Plan Assets in Employer Stock, JCX-1-02, February 11, 2002; Report of the Department of the Treasury on Employer Stock in 401(k) Plans, February 28, 2002.

[100] Section 404(a)(9).

[101] Section 1042.

assets transferred to an ESOP between April 1, 1985 and December 31, 1988;[102] and the 50% exclusion from gross income for interest received on an ESOP loan, and the related exemption from the rules governing below-market- interest loans. These rules now apply only to loans made before August 21, 1996, and certain refinancings of such loans.[103]

(b) Rules also applicable to tax credit ESOPs.

The following rules apply both to Section 4975(e)(7) ESOPs and to tax credit ESOPs: an exemption from the joint and survivor annuity requirements;[104] the diversification requirement;[105] the rule that all valuations of employer securities which are not readily tradable on an established securities market, with respect to activities carried on by the plan, must be performed by an independent appraiser;[106] the deduction for certain dividends paid on employer securities held by the ESOP;[107] and the exemption from certain requirements of the anti-cutback rule.[108]

Certain rules apply only to tax credit ESOPs.[109]

(c) Rules That Also Apply to Non-ESOPs

Finally, the following rules must be satisfied by any Section 4975(e)(7) ESOP or tax credit ESOP, and also by other specified types of plan: voting rights with respect to employer securities;[110] the right to receive benefits in the form of employer securities;[111] the requirement of a put-option with respect to unmarketable securities;[112] and the accelerated distribution rules, and the

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[102] Section 4980(c)(3).

[103] Sections 133, 7872(f)(12).

[104] Section 401(a)(11)(C).

[105] Section 401(a)(28)(B).

[106] Section 401(a)(28)(C).

[107] Section 404(k).

[108] Section 411(d)(6)(C); ERISA section 204(g)(3); Treas. Reg. Sec. 1.411(d)-4, Q & A 2(b)(2)(iv), 2(d).

[109] Sections 410(b)(6)(D), 409(b), (c), (d), (f), (i), (j), (m).

[110] Sections 409(e), 401(a)(22).

[111] Sections 401(a)(23), 409(h).

[112] Sections 401(a)(23), 409(h); Treas. Reg. Secs. 54.4975-7(b)(10), -7(b)(12).

requirements for payment of the price when the employer honors the put-option.[113]

Recommendation. We recommend a comprehensive reexamination and rationalization of the rules relating to employer securities held by retirement plans. The rules which are retained should apply to all qualified plans holding employer securities.

Discussion. These special rules relating to employer securities were enacted to protect plan participants. The need for protection appears to be the same, regardless of what type of plan holds the securities. Some rules should, perhaps, be repealed; others should be modified. The rules which are retained should apply to all plans holding employer securities, unless a good reason can be shown for departing from this principle of uniformity. Also, in light of the dangers of lack of retirement diversification highlighted by the Enron and other recent cases, we recommend that consideration should be given to outright elimination of the many incentives currently extended under the Code to plans that invest in employer securities. Such elimination would among other things have a vastly simplifying effect, but would obviously involve significant policy considerations.

19. Employer Aggregation.

Current Law. In determining whether retirement plans and other employee benefits qualify for tax-favored treatment under the Code, the employer aggregation rules[114] generally require related employers to be treated as a single employer. These employer aggregation rules apply to all types of qualified plans and also to SIMPLE IRAs, but do not apply to 457 plans. Also, the Code does not list Section 403(b) among the sections to which the aggregation rules apply.

On occasion, the IRS has taken the position that entities without owners are subject to aggregation

Recommendation. We recommend that (i) guidance be issued regarding the application of the employer aggregation rules to organizations that do not have owners, (ii) a detailed review of the affiliated service group and leased employee rules be conducted,[115] and (iii) the Treasury and the IRS should issue new, more workable separate line of business regulations.

Discussion. The employer aggregation rules generally require a specified degree of common ownership in order for aggregation to apply.

[113] Sections 401(a)(23), 409(h)(5), (6), 409(o).

[114] Sections 414(b), (c) and (m).

[115] Sections 414(m), (n).

Accordingly, they appear not to apply to governmental employers, tax- exempt organizations and other entities that do not have owners. However, on occasion, IRS has taken the position that such entities are subject to aggregation.[116] IRS has requested comments on this issue and, pending the issuance of further guidance, a good-faith compliance standard is in effect.[117]

The argument for applying the aggregation rules to 403(b) plans, as opposed to qualified plans of governmental and tax-exempt employers, is even weaker, because the Code does not list Section 403(b) among the sections to which the aggregation rules apply.

The employer aggregation rules are of fundamental importance, particularly in testing plans for compliance with the minimum coverage rules, the nondiscrimination rules, and the Section 415 limitations. Accordingly, guidance on their application to organizations that do not have owners is essential.

The affiliated service group and leased employee rules[118] were enacted in the early 1980s to address specific, and relatively narrow, abuses. Both provisions are far broader than is required to deal with the abuse, and guidance is sparse. A detailed review of these rules by Congress is long overdue.

Finally, in 1986 Congress enacted the separate line of business ("SLOB") rules[119] to provide relief for organizations that, while connected by common ownership, were in fact separate. The regulations add highly detailed and restrictive requirements that make the SLOB rules available to only very few employers. We strongly encourage the IRS to issue new, more workable regulations.

B. Other Employee Benefit Plans

1. Cafeteria Plan Elections.

Current Law. The regulations under Section 125 impose stringent restrictions on the ability of an employee to make and change elections under a cafeteria plan.

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[116] *See, e.g.* PLR 8702063 (October 16, 1986), Notice 89-23, Notice 90-73.

[117] Notice 96-64.

[118] Sections 414(m), (n).

[119] Section 414(r).

Recommendations.

1. We agree with the JCT Staff that the rules for elections under cafeteria plans should be similar to those applicable to elections under 401(k) plans.

2. We recommend repeal of the rules prohibiting deferred compensation under a 403(b) or 457 plan as a part of a cafeteria plan.

3. We recommend that the "use it or lose it" rule, under which amounts elected by a participant must generally be forfeited, unless used for qualifying expenses by the end of the year, should be changed to allow unused amounts to be (i) contributed to the employee's account under a qualified plan or (ii) used in the following plan year of the cafeteria plan, at the employer's option.

4. Finally, we recommend reconsideration of the list of benefits that may be provided under a cafeteria plan: notably, education benefits and transportation benefits would appear to be suitable candidates for inclusion, and we recommend reconsideration of the HIPAA rule that denies tax-favored treatment for long-term care insurance provided through a cafeteria plan.

Discussion. We agree with the JCT Staff that the current regulations governing cafeteria plans are unduly restrictive, and make it difficult or impossible for employers and employees to respond to changes in circumstances. In addition, we believe that widespread confusion as to how the rules operate makes it likely that there is substantial unintentional noncompliance in practice. Therefore, we support the proposal to conform the rules for elections under cafeteria plans with those for elections under 401(k) plans. This change would benefit both employers and cafeteria plan participants, and should be implemented without delay.

However, the JCT Staff's proposal would not change the rule prohibiting deferred compensation other than deferrals under a qualified cash or deferred arrangement pursuant to Section 401(k). This rule should be changed: there is no reason why a cafeteria plan should not permit deferrals under a 403(b) plan or 457 plan.

The JCT Staff's recommendation also does not address the "use it or lose it" rule, under which amounts elected by a participant must generally be forfeited, unless used for qualifying expenses by the end of the year. The rule should be changed to allow unused amounts to be (i) contributed to the employee's account under a qualified plan or (ii) used in the following plan year of the cafeteria plan, at the employer's option.

Finally, although it would not necessarily further simplification, we suggest that the list of benefits that may be provided under a cafeteria plan be reconsidered. For example, education benefits and transportation benefits would appear to be suitable candidates for inclusion. We also recommend reconsideration of the HIPAA rule that denies tax-favored treatment for long-term care insurance provided through a cafeteria plan.

2. Nondiscrimination Rules for Welfare Plans.

Current Law. Six welfare benefits are subject to some form of nondiscrimination rules, namely group term life insurance,[120] self-insured health benefits,[121] educational assistance,[122] dependent care assistance,[123] certain fringe benefits (no-additional-cost services, employee discounts and employer-operated eating facilities),[124] and voluntary employee beneficiary associations ("VEBAs").[125]

Recommendations.

1. We generally support the JCT Staff's proposal to uniformly permit exclusion from the nondiscrimination requirements relating to welfare benefits of (i) employees who have not completed 3 years of service, (ii) employees who have not attained age 25, (iii) part-time or seasonal employees, (iv) bargaining unit employees who are not included in the plan, if the applicable benefit was the subject of good faith bargaining, and (v) nonresident aliens who receive no earned income from the employer that is U.S. source income.

2. We also recommend (i) elimination of the unnecessary differences in the application of the discrimination tests, (ii) clarification of the tests, on some of which there is virtually no available guidance, (iii) extension of discrimination tests to insured health plans, and (iv) a reconsideration of the 3 years of service/ age 25 requirements, which may be too stringent for self-insured health plans.

Discussion. In 1986, as part of the Tax Reform Act of 1986, Congress enacted Section 89, the purpose of which was to enact uniform nondiscrimination rules for welfare plans. In the face of strong opposition based on its complexity, Section 89 was repealed before it took effect. The JCT Staff notes that each of the six lists of individuals that may be or are excluded from consideration in the application of nondiscrimination requirements to employee

[120] Section 79.

[121] Section 105(h).

[122] Section 127.

[123] Section 129.

[124] Section 132.

[125] Sections 501(c)(9), 505.

benefits is unique, and that it appears that the differences in the lists are attributable solely to the establishment of the lists at different times.[126]

We believe that the proposal is a useful first step, but it might usefully have gone further. Therefore, we also recommend (i) elimination of the unnecessary differences in the application of the discrimination tests, (ii) clarification of the tests, on some of which there is virtually no available guidance, (iii) extension of discrimination tests to insured health plans, and (iv) a reconsideration of the 3 years of service/ age 25 requirements, which may be too stringent for self-insured health plans. The JCT Staff may have feared reviving memories of the unsuccessful experience with Section 89: however, it should be possible to draft viable rules that do not involve the complexities of Section 89.

[126] JCT Staff Study at 227-8.