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PENSION SIMPLIFICATION

DAVID A. PRATT*

I. INTRODUCTION

Complaints about the complexity of the federal pension laws are not a recent phenomenon.¹ Almost 60 years ago, following the changes enacted by the Revenue Act of 1942, one commentator wrote that the result of legislation was “provisions so complicated that they are difficult to read and in some respects so vague that they may be hard to apply.”² At that time, there were only four basic plan qualification requirements set out in the Internal Revenue Code (“IRC”).

The current rules are largely the product of the Employee

* Professor of Law, Albany Law School; of counsel (an independent contractor) to Hodgson Russ LLP, Albany, New York; and to Downs, Rachlin & Martin PLLC, Burlington, Vermont. My thoughts relating to pension simplification were greatly helped by discussions with members of the Executive Committee and the Employee Benefits Committee of the Section of Taxation of the New York State Bar Association (NYSBA), with particular thanks to Andrew Stumpff. The views expressed in this article do not necessarily represent the views of NYSBA or any of its members or committees. This article is dedicated to my friend Ed. Harville, who died while it was being written.

1. For examples of interesting discussions of pension complexity and the need for simplification see Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, JCS-3-01, Apr. 2001; New York State Bar Association, *Special Committee on Pension Simplification, A Process Awry: Federal Pension Laws*, 43 TAX NOTES 463 (1989); Joint Committee on Taxation, *Overview of Present Law Tax Rules Relating to Qualified Pension Plans* (JCX-30-98), May 4, 1998, reprinted in TAX NOTES TODAY, May 5, 1998, and in 25 BNA PENSION & BENEFITS REP. 1135 (1998); New York State Bar Association, Special Committee on Pension Simplification, *ERISA: A Process Still Awry, A Need to Simplify*, 83 TAX NOTES 1053 (1999); Gene Steuerle, *Why Pension Simplification Is So Difficult To Achieve*, 80 TAX NOTES 253 (1998); Warshawsky, *Minimum Distribution Requirements: Reform or Remove Them*, TAX NOTES, Sept. 30, 1998, p. 1133; Joint Committee on Taxation Staff, *Overview of Present Law and Issues Relating to Employer-Sponsored Retirement Plans for Ways and Means Oversight Hearing*, March 23, 1999, reprinted at 55 DTR (BNA) L-5 (Mar. 23, 1999); David A. Pratt & Diane Bennett, *Simplifying Retirement Plan Distributions*, N.Y.U. 57TH INSTITUTE ON FED. TAX'N EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION, ch. 5 (1999); David J. Kautter, *Employee Benefits: Statutory Simplification*, 18 TAX MGMT. COMP. PLAN. J. 51 (Mar. 2, 1990); Association of Private Pension and Welfare Plans (“APPWP”), *Gridlock: Pension Law in Crisis and the Road to Simplification* (Sept. 1989), reprinted in TAX NOTES TODAY, Oct. 20, 1989, 89 TNT 213-24 available at <http://www.lexis.com> (last visited Sept. 6 2002) (recommending 29 specific simplifications of the law). The 1989 New York State Bar Association Committee report listed, as Appendix A, those areas of current law most in need of simplification. See 43 TAX NOTES 463, at 476-77 (1989).

2. John W. Drye, Jr., *Pension and Other Deferred Compensation Plans under Section 162 of the Revenue Act of 1942*, 2 N. Y. U. INST. FED. TAX'N 48, 50 (1943).

Retirement Income Security Act of 1974 ("ERISA"),³ a statute that made many worthwhile changes, but was enacted in response to the very different economic and social conditions of the mid 1960s. Subsequent legislation has rarely represented good pension policy: generally, it has been revenue-driven or inspired by a desire to thwart the selfish machinations of highly compensated business owners and executives.⁴

As Pamela Perun and Eugene Steuerle have pointed out,

ERISA at 25 is no longer a sensible or practical statute. And the pension system it governs is an uncoordinated jumble of plans and a labyrinth of rules and regulations, sometimes exhibiting neither rhyme nor reason. . . . Prior to ERISA, IRC section 401(a), the major tax statute for pension plans, ended with section 401(a)(10). In 1999, it ended with IRC section 401(a)(34). This averages out to one fundamental legal requirement added for each year since ERISA was enacted.⁵

This complexity has been acknowledged recently by the Joint Committee on Taxation ("JCT") that has noted that the federal pension laws "are recognized as among the most complex set of rules applicable to any area of the tax law,"⁶ and that

[t]he number of different tax-favored retirement arrangements increase complexity in the pension rules because different rules are needed for each type of arrangement. A great deal of simplicity could be achieved, for example, if employers were permitted to choose from only one or two model pension plans. However, this would also greatly reduce the flexibility provided employers and employees under present law.⁷

3. PUB. L. NO. 93-406 (codified as amended in various sections of Titles 26 and 29 of the U.S. Code).

4. Governmental and church plans, as defined in 29 U.S.C. §1002(32)-(33), and 26 U.S.C. § 414(d-e), are exempt from many of the normal requirements of ERISA and the Code. Similarly, multi-employer plans, which by definition result from collective bargaining, are subject to different rules. The different rules that apply to governmental, church and multi-employer plans are beyond the scope of this article.

5. PAMELA PERUN & C. EUGENE STEUERLE, *ERISA at 50*, in ALL-ABA COURSE OF STUDY MATERIALS, PENSION POLICY CONFERENCE, ERISA AFTER 25 YEARS (Course No. SE40, September-October 1999).

6. Joint Committee on Taxation, *Overview of Present-Law Rules Relating to Qualified Pension Plans* (JCX-30-98), May 4, 1998, reprinted in TAX NOTES TODAY, 98 TNT 86-21, May 5, 1998, available at www.lexis.com (last visited Sept. 6 2002).

7. Joint Committee on Taxation, *Overview of Present Law and Issues Relating to Employer-Sponsored Retirement Plans*, 55 DTR L-5, reprinted in THE DAILY TAX REPORT (BNA), March 23, 1999. 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.

Gene Steuerle, *Why Pension Simplification is So Difficult to Achieve*, 80 TAX NOTES 253 (1998).

The JCT report also suggests that the following factors should be considered in

Why is simplification a worthwhile goal? First, and most importantly, the complexity of the rules discourages employers – particularly small employers – from adopting plans. The Bureau of Labor Statistics found that, in 1999, 56% of full-time employees were covered by retirement plans, while only 21% of part-time employees were covered.⁸ Eighty-one percent of workers in establishments with 2,500 or more employees were covered, but only 30% of those in establishments with fewer than 50 employees were covered.⁹ In recent years, Congress has attempted to encourage small employers to adopt plans, but many small employers are totally unaware of these changes. According to *The 2002 Small Employer Retirement Survey* (“SERS”), involving employers with fewer than 100 employees, few were familiar with the important pension changes enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”):

‘Sixty-eight percent of sponsors and 86 percent of non-sponsors (companies not sponsoring a plan) say they are not familiar with this law, which has important provisions for employment-based retirement plans. . . . The 2002 SERS finds that 87 percent of small-employer non-sponsors were unaware that the new tax law allows them to take a tax credit of up to 50 percent for the start-up costs of establishing and administering a new retirement plan,’ said Dallas Salisbury, president and CEO of EBRI. ‘When told of the new tax credit, 68 percent of non-sponsors said it would make it more attractive for them to offer a retirement plan.’¹⁰

relation to any simplification proposal: “

(1) [T]he extent to which the proposed change is consistent with the underlying policy objective of the rule that is altered; (2) whether a complete revision of rules that employers and plan administrators understand and use should be made solely in the interest of simplification; (3) whether additional legislation with respect to a rule that has already been subject to significant legislation itself creates complexity; (4) the extent to which transition rules and grandfather rules contribute to complexity; and (5) whether any attempt to simplify the rules relating to employer-provided pension plans should be required to be revenue neutral with respect to present law.

8. U.S. DEPT. OF LAB., BUREAU OF LAB. STAT., *EMPLOYEE BENEFITS IN PRIVATE INDUSTRY*, 1999 (Dec. 19, 2001), Tbl.1.

9. *Id.* Similarly, a recent General Accounting Office study found that the percentage of firms sponsoring a retirement plan was only 12.9% for those with fewer than 10 employees, 28.6% for those with 10-24, and 39.7% for those with 25-49. GENERAL ACCOUNTING OFFICE, *Private Pensions: Improving Worker Coverage and Benefits*, GAO-02-225 (Apr. 2002), (citing the Employee Benefit Research Institute); see also Patrick J. Purcell, *Pension Sponsorship and Participation: Summary of Recent Trends*, Washington, D.C., CONG. RES. SERVICE, 2001; Alicia H. Munnell *et al.*, *How Important Are Private Pensions?* available at http://www.bc.edu/bc_org/avpl/csom/executive/crr/issues/ib_8.pdf (last visited July 12, 2002).

10. Employee Benefit Research Institute, Press Release, *Most Small Businesses Unaware of New Tax Law Incentives to Sponsor a Retirement Plan*, Washington, D.C., May 7, 2002, available at <http://www.ebri.org/prrel/pr596.pdf> (last visited

The rules for traditional defined benefit pension plans are especially complex, and this has undoubtedly been a major factor in the recent shift from defined benefit plans to defined contribution plans, such as 401(k) plans. In 1975, total defined benefit plan assets were \$186 billion, more than twice the total defined contribution plan assets of \$74 billion. In 1996, defined benefit plan assets had increased to \$1.6 trillion, while defined contribution plan assets had increased to \$1.5 trillion.¹¹ Over the same period, annual contributions to defined benefit plans increased by 50%, from \$24 billion to \$36 billion, while contributions to defined contribution plans increased by over 900%, from \$13 billion to \$134 billion.¹² According to the Congressional Research Service:

In recent years, the personal savings rate — the percentage of personal disposable income not devoted to current consumption — has declined substantially. . . . [T]he decline in the savings rate that has occurred since the mid-1990s is unprecedented in the post World War II era in the United States. In 2000, the personal savings rate was negative for the first time since 1933, during the Great Depression.

The savings rate has declined steadily from a high of 10.6% in 1975 to 9.2% in 1985, 5.6% in 1995, 2.2% in 1999 and -0.1% in 2000.¹³ An estimated 67.6 million workers between the ages of 25 and 64 (62.6% of workers) did not own a retirement savings account of any kind.¹⁴

At the same time, retirement income adequacy for most Americans has suffered a downward trend, despite the exceptionally healthy economy throughout the 1990s:

In 1998, every group of near-retirees except those at the very top lost ground compared with their counterparts in 1983. The contraction of traditional defined benefit pension plans and their replacement by defined contribution plans appears to have helped rich, older Americans

Sept. 6, 2002).

11. Congressional Research Service Report for Congress, *Pension Coverage and Participation: Summary of Recent Trends*, 2000 TNT 222-24, Nov. 6, 2000, reprinted in TAX NOTES TODAY, Nov. 16, 2000 (the "CRS Report"), available at <http://www.lexis.com> (last visited Sept. 6, 2002).

12. *Id.*

13. Congressional Research Service Report for Congress, *Retirement Savings and Household Wealth in 1997: Analysis of Census Bureau Data*, 2001 TNT 75-16, Apr. 5, 2001, available at <http://www.lexis.com> (last visited Sept. 6, 2002).

14. *Id.* (reflecting the CRS Analysis of the 1996 Panel of the Census Bureau's Survey of Income and Program Participation). The mean and median values of all retirement accounts in a household were as follows:

	Mean	Median
Workers 25 to 34	20,259	8,000
Workers 35 to 44	41,582	20,000
Workers 45 to 54	57,845	28,000
Workers 55 to 64	72,347	36,668

Id. 77% of all workers 55 to 64 years old lived in households with retirement savings of between zero and \$37,000 in 1997. *Id.*

but hurt a large group of lower-income Americans.¹⁵

Given the well-documented financial problems facing the Social Security system as the baby boomers begin to retire, a strong private pension system to supplement Social Security is now more important than ever.

A second major reason supporting simplification is the cost of complying with the current rules. An employer sponsoring, or thinking of sponsoring, a plan needs to retain expert advice to help the employer:

- to choose which type of plan best meets its needs;
- to decide between the many plan design alternatives in such areas as eligibility of employees to participate, vesting of benefits, and the contribution or benefit formula;
- to communicate the plan to employees; and
- to keep the plan in compliance with the constantly changing requirements of the law and regulations.

Every dollar spent on these administrative expenses is a dollar that could otherwise have been spent on improving the retirement benefits actually payable to employees. A recent study found that a 1% annual differential in administrative expenses, over a 40-year period, results in a 27% difference in assets available to an employee at retirement age.¹⁶

The ultimate simplification would be to have no rules at all for qualified retirement plans, but this would be patently absurd. Accordingly, in recommending changes which would simplify the operation of retirement plans, this author has considered (1) the need to protect employee rights, (2) the need to ensure that meaningful benefits are provided to rank and file employees and (3) the importance of expanding coverage under the private pension system.

II. QUALIFIED RETIREMENT PLANS: CHANGES DISCUSSED BY THE JOINT COMMITTEE ON TAXATION STUDY

In April 2001, the staff of the Joint Committee on Taxation issued a detailed study (the "JCT Study")¹⁷ of the federal tax system

15. Press Release, Middle Americans' Retirement Wealth Fell as Stock Market Soared, New Study Reveals Boom a Retirement Bust for All but the Richest; Next Retirees More Likely than Predecessors to Live in Poverty (May 2, 2002) (quoting EDWARD N. WOLFF, *Retirement Insecurity: The Income Shortfalls Awaiting the Soon-to-Retire*, Economic Policy Institute, Washington, D.C).

16. HAZEL BATEMAN & OLIVIA S. MITCHELL, *New Evidence on Pension Plan Design and Administrative Expenses*, PENSION RESEARCH COUNCIL, Working Paper PRC-2000-10 at 1 (Mar. 2002), available at <http://prc.wharton.upenn.edu/prc/PRC/WP/WP2002-10.pdf> (last visited Sept. 6, 2002).

17. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, JCS-3-01 (Apr. 2001) [hereinafter

and recommendations for simplification. The JCT Study includes numerous recommendations for simplification of the rules governing qualified plans. This article will first address those issues that were covered in the JCT Study.

A. Definition of Compensation

The IRC provides different definitions of compensation for different qualified plan purposes. There are three main definitions relevant to qualified plans:

1. Section 415 compensation, which is primarily used in applying the section 415 limitations on contributions and benefits;
2. Section 404 compensation, used in calculating the deduction allowable to the employer for its contributions to the plan under section 404; and
3. Section 414(s) compensation, used in testing 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. According to the JCT Study, there are 5 permissible definitions of section 415 compensation, 5 permissible definitions of section 404 compensation, and 22 permissible definitions of section 414(s) compensation.¹⁸ There is also a special definition of compensation for SIMPLE plans.¹⁹ The JCT Study recommends a single definition for all qualified plan purposes, including determining plan benefits. The uniform definition would be: (1) the amount reportable as compensation on Form W-2, plus (2) elective contributions, including section 125 salary reductions.²⁰

If the plan year or the employer's taxable year is other than the calendar year, then the compensation used would be compensation for the calendar year ending within that plan year or taxable year. The staff notes that it may be appropriate to allow imputed compensation or compensation from a prior employer to be used under a defined benefit plan in certain cases.²¹ This change would be helpful; however, an equal degree of simplification would be achieved, and additional flexibility retained, if the uniform definition were used for all discrimination testing purposes, but not for purposes of the benefit formula.²² Reducing the number of alternative definitions of

"JCT Study"].

18. *Id.* at 172-73, Tbl. 13, (Definitions of Compensation for Qualified Retirement Plan Purposes). All page references to the JCT Study are to Volume II, Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System.

19. 26 U.S.C. § 408(p)(6)(A) (2000). SIMPLE plans are discussed in section II.E below.

20. JCT Study, at 170.

21. *Id.*

22. This approach was suggested by the Association of Private Pension and

compensation will reduce complexity in plan design and administration. In addition, it is important to have uniformity in applying statutory requirements such as the section 415 limitations and the nondiscrimination rules. However, it is important to allow employers flexibility in determining which definition of compensation to use in determining benefits under a plan. Any potential abuse of this flexibility should be avoided by the fact that the employer will have to use the uniform definition in testing the plan under the nondiscrimination rules.

B. Minimum Coverage and Nondiscrimination Rules for Qualified Plans

The Treasury regulations implementing the coverage and nondiscrimination rules are exceptionally complex, and often require detailed computations. They reflect a change to objective mathematical tests from the facts and circumstances approach that prevailed before enactment of the Tax Reform Act of 1986 ("TRA 86"). A qualified plan must cover a minimum percentage of the employer's non-highly compensated employees (NHCEs).²³ 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.

In the context of retirement plans, nondiscrimination has a specialized meaning, and is strictly a tax issue, which is not addressed by ERISA. The basic nondiscrimination rule requires that either the contributions to, or the benefits under, the plan not discriminate in favor of HCEs.²⁴

In its simplest form, nondiscrimination in this context requires that

1. a defined benefit plan may not provide benefits for HCEs that are higher, as a percentage of compensation, than the benefits provided for NHCEs, and
2. a defined contribution plan may not provide contributions for HCEs that are higher, as a percentage of compensation, than the

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, available at <http://www.lexis.com> (last visited Sept. 6, 2002).

23. 26 U.S.C. §§ 401(a)(3), 410(b)(1) (2000). The term "highly compensated employee" is defined in section 414(q). Essentially, a HCE is any person who (1) earned at least \$80,000 (indexed) from the employer during the preceding year (and, if the employer so elects, was among the highest paid 20% of employees) or (2) owned, directly or by attribution (for instance, from a family member), more than 5% of the employer at any time during the current or preceding year. Any plan participant who is not a HCE is a non-highly compensated employee (NHCE).

24. See 26 U.S.C. § 401(a)(4) (2000), at n.23 (summarizing the definition of "highly compensated employee"; 26 U.S.C. § 414(q) (2000)).

contributions provided for NHCEs.²⁵

Even in its simplest form, this rule is not invulnerable to challenge: should the tax system subsidize an annual benefit of \$120,000 for an employee making \$150,000 per year if the plan provides a benefit of only \$16,000 for an employee making \$20,000 per year? The HCE presumably has other assets, and is in a better position than the NHCE to save at least part of his or her disposable income for retirement. Even accepting that, under a voluntary pension system, there must be incentives for the decision-makers (who are usually HCEs) to adopt a plan, should the plan not be required to provide at least a minimum level of benefits for low-paid employees.

Under current law, the "nondiscrimination" rules permit benefits for HCEs that can be significantly greater, in proportion to compensation, than those provided for NHCEs. First, the nondiscrimination rules are linked to the employee coverage rules: a plan will satisfy the nondiscrimination rules if it provides a "nondiscriminatory" benefit to a group of employees that satisfies the employee coverage rules of Code section 410(b). The practical effect of this rule is that a plan can satisfy the nondiscrimination rules while providing benefits to significantly less than all of the NHCEs.

Second, the plan's contributions or benefits can be "integrated" or coordinated with Social Security, the effect of which is to increase the contributions or benefits for the HCEs in relation to those for the NHCEs.²⁶ Prior to the changes enacted by the Tax Reform Act these rules could be defended, with some degree of plausibility, on the basis that the overall level of benefits, under Social Security and the private retirement plan, was relatively level.²⁷ The "permitted disparity" rules of current law are basically indefensible, and are extremely

25. See 26 U.S.C. § 401(a)(4) (2000). Under the rule, either the contributions or the benefits (but not both) must be nondiscriminatory. 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. *Id.*

26. 26 U.S.C. § 401(l) (2000) and Treas. Reg. §§ 1.401(l)-1 through 1.401(l)-6 (2000).

27. Even under prior law, the conceptual basis for integration was shaky at best.

Employers are paying a percentage of their workers' salaries into Social Security. However, the payment is a *tax*, not a pension contribution. The benefits for which the employer is contributing are not for its current workers, but for workers now retired, from an earlier generation, perhaps before this employer was even in business. To construe the employer's contribution as something other than a general tax and the employee's benefit as somehow purchased in part by the employee's employer is carrying a useful political fiction to an illogical extreme.

Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 435, 485 (1987); See generally Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income And The Problem of Integrating Private Pensions And Social Security*, 30 LOY. L.A. L. REV. 1063 (1997).

complex.²⁸

Accordingly, I recommend that the permitted disparity rules be repealed in their entirety. The JCT Study made 3 recommendations in this area:²⁹

1. *Excludable Employees should be disregarded in applying the minimum coverage and general non-discrimination rules, even if some or all of them are covered by the plan.*

This proposal should be enacted. Enactment 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. One further change should also be made: the top-heavy rules³⁰ should be modified to clarify that, if excludable employees are allowed to participate, the employer is not required to provide the top-heavy minimum contribution or benefit until they have satisfied the plan's normal eligibility requirements.

2. *The cross-testing rules should be codified, and the purposes for which the cross-testing rules may be used should be clarified.*

With reference to this recommendation, the JCT Study noted that:

[t]he 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.³¹

Cross-testing is made easier by the fact that a plan can be tested on the basis of "rate groups" rather than on the basis of the entire plan.³² Under this approach, provided that the group of employees

28. The rules for integrating defined benefit plans are extraordinarily complex. See Treas. Reg. § 1.401(l)-3 (2000). The root of the complexity is the difficulty in determining the appropriate portion of the social security benefit attributable to the contributions of the employer whose plan is to be integrated. JOHN H. LANGBEIN & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFITS LAW*, 3D ED. 320 (Foundation Press 2000). For a critique of the rationale underlying integration see Nancy J. Altman, *Rethinking Retirement Income Policy: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 435 (1987).

29. JCT Study, at 182-83.

30. See generally, 26 U.S.C. § 416 (2000) (setting forth special rules for top-heavy plans).

31. JCT Study, at 183.

32. A rate group exists for each HCE participating in the plan, and consists of that HCE and all other participants (HCEs and NHCEs) whose allocation rate (if

that receives each level of benefits under the plan satisfies a liberalized version of the nondiscriminatory classification test, that level of benefits is nondiscriminatory.³³ This technique is based upon, and encouraged by, IRS regulations.³⁴

However, since the JCT study was published, new final cross-testing regulations have been issued.³⁵ Although cross testing is now far more prevalent and is used far more aggressively than in the past, the ability to cross test has long been available.³⁶ Accordingly, I suggest that a better approach would be for the Treasury Department and the IRS: (1) to solicit comments and recommendations for improvement to the current rules, together with information as to their effect on the formation and administration of both large and small plans; and (2) to consider whether to issue new proposed regulations in the light of that information. 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.

For an employer whose HCEs are, in general, older than its NHCEs, cross testing allows the employer to replicate the contribution pattern of a defined benefit plan (significantly higher contributions, as a percentage of compensation, for the older HCEs than for the younger NHCEs) without incurring the commitments associated with maintaining a defined benefit plan. Accordingly, any assessment of the effects of the cross-testing rules should attempt to determine whether, and to what extent, (1) employers who might otherwise have adopted defined benefit plans are using cross-tested plans instead and (2) whether the NHCEs covered by those cross-tested plans are in fact receiving benefits comparable to those which

the plan is being tested on the basis of contributions) or equivalent benefit accrual rate (if the plan is being tested on the basis of benefits, as would be the case for a cross-tested defined contribution plan) is equal to or greater than the HCE's rate. Treas. Reg. §§ 1.401(a)(4)-2(c)(1), 1.401(a)(4)-3(c)(1) (2000).

33. The ratio percentage of the rate group (percentage of NHCEs in the group divided by percentage of HCEs in the group) must equal or exceed the lesser of (i) the ratio percentage of the plan or (ii) the midpoint between the safe and unsafe harbor percentages applicable to the plan. Treas. Reg. §§ 1.401(a)(4)-2(c)(3), -3(c)(2) (2000). Thus, for instance, if 90% of the employees of the employer are NHCEs, the safe harbor percentage is 27.5% and the unsafe harbor percentage is 20%, giving a midpoint of 23.75%. Accordingly, if the rate group includes 100% of the HCEs, it need only include 23.75% of the NHCEs. If the rate group includes only 50% of the HCEs, it need only include 11.875% of the NHCEs. These relatively brief extracts from the nondiscrimination regulations will, I hope, give the reader a sense of the crazy world of nondiscrimination testing, where the hapless plan administrator (Alice) tries to satisfy the mathematical cravings of the Treasury Department (the Red Queen), while being uncomfortably aware of the sanction for failure ("Off with her head!").

34. Treas. Reg. § 1.401(a)(4)-8 (2000).

35. TD 8954, 66 Fed. Reg. 34535 (2001).

36. See, e.g., Rev. Rul. 81-202, 1981-2 C.B. 93 (setting forth the pre- TRA 86 rules for determining plan comparability).

they would receive under a defined benefit plan.

3. *The ratio percentage test should be modified to allow more plans to use it.*

Finally, the JCT Study 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 non-highly 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.

This change should 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. Second, there is a strong argument that the current 70% threshold – though sanctioned by long usage – is too low. Why should an employer be able to exclude at least 30% of its non-excludable employees, as well as all of its excludable employees, for any reason it chooses?

In the author's opinion, the current rules permit far too many employees to be excluded completely from participation and allow benefits for HCEs that are far too generous when compared to the benefits provided for NHCEs. Accordingly, although any progress must most likely be incremental, and political realities may prevent attainment of the goal, this article supports the position taken by Daniel Halperin and Alicia Munnell:

The centerpiece of improving coverage for the rank and file requires jettisoning the complicated Treasury regulations regarding participation of the highly compensated versus that for the non-highly compensated and replacing it with the requirement that a qualified pension plan must cover all employees (in a given line of business). Under this requirement, no one earning less than any participant could be excluded because of the nature of his job. The only exception would be employees earning less than \$20,000 (indexed for annual wage), who would be covered under the public USA-type plan. Unlike current law, the new provisions would not tolerate any disparity between the benefits for the higher and lower paid. No longer would it be acceptable for the participation from the highly compensated to be not "too much" greater than the level of participation from the remainder of the work force, and for the average benefit of the non-highly compensated to be 70% of that for the highly compensated. Nondiscrimination would mean that the same provisions cover all employees. If the plan failed this simple test, none of the participants would be eligible for favorable tax treatment.³⁷

37. DANIEL I. HALPERIN & ALICIA H. MUNNELL, *How the Pension System Should Be Reformed*, BROOKINGS INSTITUTION CONFERENCE ON ERISA AFTER 25 YEARS: A FRAMEWORK FOR EVALUATING PENSION REFORM (Sept. 1999), available at www.brook.edu/es/events/erisa/99papers/erisa10.pdf (last visited Sept. 6, 2002). I

C. *The Nondiscrimination Regulations under Section 401(a)(4)*³⁸

The regulations under Code section 401(a)(4) are very complex, and deal with (1) nondiscrimination in the amount of contributions or benefits, (2) the nondiscriminatory availability of benefits, rights and features under the plan and (3) nondiscrimination in special situations, such as plan amendments.

The regulations have been widely, and correctly, criticized for their complexity. It is not clear why it was thought necessary or appropriate to replace the prior facts-and-circumstances approach, which had worked perfectly well for many years. The regulations fail to achieve their avowed purpose of establishing bright line rules because they are too complex.³⁹ Furthermore, [t]he complex numerical test actually legalizes discrimination against rank-and-file workers to a greater extent than almost any benefits professional would previously have deemed possible.⁴⁰ According to the American Academy of Actuaries:

[t]he first and foremost option to encourage the creation of private pension plans is to reduce the complexity of regulations. . . . Another approach. . . is for Congress to provide plans that adopt certain provisions with relief from particular costly or complex regulatory requirements. . . . For example, in exchange for a plan offering shorter vesting, partial indexing, or enhanced portability, Congress could permit less costly methods of discrimination testing. . . . Among existing regulations, those that require elaborate tests to ensure that plans do not discriminate in favor of more highly compensated workers are most

would modify the proposal in one respect: if the plan failed to satisfy the new test, I would penalize only the HCEs (or some similar group). Rank and file employees should not be penalized for plan design decisions over which they had no control.

38. A comprehensive discussion of the nondiscrimination rules would require a separate article, so this paper only addresses the topic briefly. Numerous articles discuss the desirability or otherwise of numerical nondiscrimination rules; see, e.g., Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 428 (1984); Michael W. Melton, *Making the Nondiscrimination Rules of Tax-Qualified Retirement Plans More Effective*, 71 B.U. L. REV. 47, 67 (1991); see generally the following additional references: Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Bearable?*, 55 U. CHI. L. REV. 790 (1988); Joseph Bankman, *The Effect of Anti-Discrimination Provisions on Rank-and-File Compensation*, 72 WASH. U. L. Q. 597 (1994); Douglas W. Ell, *Fallacies and Structural Flaws of Complex Numerical Nondiscrimination Testing*, 58 TAX NOTES 1775 (March 29, 1993); Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 435 (1987).

39. "The present nondiscrimination and coverage rules provide enormous work for actuaries and consultants, with little benefit to employees and employers." Douglas Ell, *Perspective: The "Perfect" Retirement Plan*, 12 BENEFITS LAW JOURNAL (no. 4) 45, 46 (Winter 1999).

40. Douglas W. Ell, *Fallacies and Structural Flaws of Complex Numerical Nondiscrimination Testing*, TAX NOTES TODAY, April 5, 1993, 93 TNT 75-88, available at <http://www.lexis.com> (last visited Sept. 6 2002).

in need of simplification.⁴¹

The JCT Study 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.”⁴² This assessment is correct. 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.⁴³ However, any significant changes to these rules cause additional complexity and disruption for existing plan sponsors.

There is a strong argument that all of the current regulations under Code 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.⁴⁴ However, changing such fundamental rules again, so soon after IRS issued the new cross-testing regulations, would be unduly disruptive. Accordingly, as suggested above, a better approach would be for the Treasury Department and the IRS to conduct a systematic review of the regulations, with public input. 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.

D. Vesting

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

41. Retirement Income Security, American Academy of Actuaries Public Policy Monograph, 1998 No. 1.

42. JCT Study, at 183.

43. In 1989, the Association of Private Pension and Welfare Plans identified two fundamental misconceptions in pension regulation: evil plan myopia (“regulators’ tendency to formulate general rules by (1) considering only those few plan sponsors with abusive intent, and (2) failing to consider the effect of the regulation on the vast majority of sponsors, who have no such intent.”) and computer omnipotence. APPWP, *Gridlock: Pension Law in Crisis and the Road to Simplification*, Sept. 1, 1989, reprinted in TAX NOTES TODAY Oct. 20, 1989, 89 TNT 213-24, available at <http://www.lexis.com> (last visited Sept. 6, 2002).

44. Douglas W. Ell, *Fallacies and Structural Flaws of Complex Numerical Nondiscrimination Testing*, TAX NOTES TODAY, April 5, 1993, 93 TNT 75-88, available at <http://www.lexis.com> (last visited Sept. 6, 2002).

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.⁴⁵

If the plan is top-heavy, then it must provide either (1) 100% vesting after three years of service or (2) graduated vesting, beginning at 20% after two years of service with 20% per year thereafter, resulting in 100% vesting after six years of service.⁴⁶

Certain years of service may be disregarded for vesting purposes, including service performed before the adoption of the plan.⁴⁷ The JCT Study recommends that the vesting requirements for all qualified plans be made uniform, by applying the top-heavy vesting schedules to all plans.⁴⁸ EGTRRA has already enacted this change for employer matching contributions, effective generally for contributions for plan years beginning after 2001,⁴⁹ so the recommendation would essentially affect employer non-matching contributions to both defined benefit and defined contribution plans.

The author supports this proposal. In addition, the author suggests that it is time to reconsider the rule allowing the plan to disregard pre-plan service. An employee who has worked for the employer for several years before a plan is adopted has already suffered through accruing no benefits during that period. To allow pre-plan service to be disregarded is unfair.

It is now more widely understood than it was 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 median job tenure in the American economy in 2000 was about 3½ years, which is less than the number of years of service needed for full vesting under 3 of the 4 minimum vesting schedules (5 year cliff, 3 to 7 year graded and 2 to 6 year top heavy graded).⁵⁰ About 25% of all workers had been with their current employer for 12 months or less.⁵¹ 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 (1) matching contributions and (2) top-heavy years. The author suggests that this change should be accompanied by repeal – or at least further

45. 26 U.S.C. § 411(a)(2) (2000), ERISA § 203(a)(2) (2000).

46. 26 U.S.C. § 416(b) (2000).

47. 26 U.S.C. § 411(a)(4) (2000), ERISA § 203(b) (2000).

48. JCT Study at 184.

49. 26 U.S.C. § 411(a)(12) (2000), ERISA § 203(a)(4) (2000).

50. U.S. DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS, *Employee Tenure Summary*, available at www.bls.gov/news.release/tenure.nr0.htm (last visited Sept. 6, 2002).

51. *Id.*

simplification – of the top heavy rules, as discussed below.⁵²

E. SIMPLE Plans

SIMPLE plans were introduced by the Small Business Job Protection Act of 1996 (SBJPA). These plans come in two forms: SIMPLE IRAs and SIMPLE 401(k) plans.⁵³ Although most of the rules are the same for both types of SIMPLE plans, there are some differences:

- A State or local government employer may adopt a SIMPLE IRA but not a SIMPLE 401(k) plan;
- The contribution rules differ: the sponsor of a SIMPLE IRA has the option to reduce the required matching contribution, but the sponsor of a SIMPLE 401(k) plan does not;
- The SIMPLE IRA eligibility rules are less flexible than the SIMPLE 401(k) eligibility rules; and
- Under a SIMPLE IRA that provides for matching contributions, the Code section 401(a)(17) compensation limitation does not apply. The limitation does apply to a SIMPLE IRA that provides for non-elective contributions, and also to a SIMPLE 401(k) plan.⁵⁴

The JCT Study addresses the first 3 differences described above by recommending that the rules for SIMPLE IRAs and SIMPLE 401(k) plans be conformed by:

- Allowing State and local government employers to adopt SIMPLE 401(k) plans;
- Applying the same contribution rules to SIMPLE IRAs and SIMPLE 401(k) plans; and
- Applying the employee eligibility rules for SIMPLE IRAs to SIMPLE 401(k) plans. Though the SIMPLE IRA eligibility rules are less flexible than the SIMPLE 401(k) rules, they are easier to apply.⁵⁵

The JCT Study does not address the discrepancy relating to the Code section 401(a)(17) compensation limitation. The author supports these proposals. With respect to the contribution rules, conformity could be achieved by extending the option to reduce the required match to SIMPLE 401(k) plans or by eliminating the option for SIMPLE IRAs. The author recommends the former, as it provides additional flexibility, particularly in difficult economic times, to small employers for whom flexibility is generally very important.

52. See section III.D. *infra*.

53. 26 U.S.C. §§ 401(k)(11), 408(p) (2000).

54. 26 U.S.C. §§ 401(a)(17), 408(p)(2)(B)(ii) (2000).

55. JCT Study, at 186-87.

The difference between the rules relating to the compensation limitation should be eliminated by extending the limitation to SIMPLE IRAs that provide for matching contributions.

SIMPLE plans were intended to provide a less complex retirement arrangement whose availability is restricted to smaller employers. The proposed changes are sensible as they simplify the rules by eliminating some unnecessary differences between the two types of SIMPLE plans.

At present, the SIMPLE IRA generally offers more advantages to an employer than the SIMPLE 401(k) plan. However, the JCT Study decided against recommending repeal of the SIMPLE 401(k) alternative:

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.⁵⁶

The future of SIMPLE plans should not be considered in isolation. In 1996, only 37% of employees of companies with fewer than 100 employees participated in any retirement plan. We need to continue to study why smaller employers do not sponsor plans, and to design a plan that is responsive to their concerns. The answer may well be that the design of the plan is far less important than the tax incentives for sponsoring a plan.

SIMPLE plans do appear to be gaining greater acceptance. According to the Investment Company Institute, during 2000, the number of SIMPLE IRA plans increased by 34%, the number of participants increased by 36%, and the assets increased by 47%.⁵⁷ However, according to *The 2002 Small Employer Retirement Survey* ("SERS"), involving employers with 5 to 100 full-time workers, 31% of non-sponsors have never heard of SIMPLE plans and 51% have never heard of the other type of plan designed to appeal to small employers, the simplified employee pension plan (SEP).⁵⁸ This suggests a need for increased educational outreach efforts by the IRS.

There appears to be no good reason to continue to allow both SEPs and SIMPLE plans, with their confusingly different rules. In both cases, the rules are too complex for easy comprehension by small employers without access to expert advice, and require consideration of numerous statutory provisions. The rules, once simplified, should be centralized in a single Code section and, if references to other

56. JCT Study, at 187.

57. Investment Company Institute, *Institute Releases Ad Hoc Survey on SIMPLE IRAs as of June 30, 2001* (Sept. 28, 2001), available at http://www.ici.org/retirement/simple_ira_stats_6_2001.html.

58. *The 2002 Small Employer Retirement Plan Survey (SERS), Summary of Findings* 5, available at <http://www.ebri.org/sers/2002/02sersof.pdf> (last visited Sept. 6, 2002). The rules for SEPs are set out in 26 U.S.C. § 408(k) (2000).

statutory provisions are inescapable (e.g., some limited references to ERISA), then that Code section should include specific cross-references.

Further, there is one rule common to SEPs and SIMPLE IRAs – that the employer may not restrict withdrawals by an employee⁵⁹ – that makes no sense and should be repealed.

According to the SERS, 22% of small employers offered a SIMPLE plan, and 9% offered an SEP,⁶⁰ which suggests that SIMPLE plans, rather than SEPs, should be retained. The 2000 SERS concluded that:

[L]ong-term efforts to increase coverage among small employers have the greatest potential for success if they include: education of workers, so that they view retirement planning and saving as a personal priority and communicate their desire for a retirement plan to their employer; ongoing good economic conditions, so that business profits and the affordability of plan sponsorship improve; and policy approaches such as simplification and tax credits that help make plans more affordable.⁶¹

F. Definitions of Highly Compensated Employee and Owner

Code section 414(q), which defines the term “highly compensated employee” (HCE), whose primary purpose is in testing whether a plan satisfies the employee coverage and nondiscrimination requirements, including the special nondiscrimination tests (the actual deferral percentage and actual contribution percentage tests) for 401(k) plans.⁶²

Another term, “key employee,” defined differently,⁶³ 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.⁶⁴ Other employee benefits rules hinge on whether an individual is a 5% owner⁶⁵ or an owner-employee (as defined in section 401(c)(3)).

The JCT Study recommends that uniform definitions be used for all qualified plan purposes, and that many of the statutory terms and definitions be repealed. Specifically:

1. Five percent owner status would continue to be relevant for

59. 26 U.S.C. §§ 408(k)(4) and 408(p)(3) (2000).

60. *The 2002 Small Employer Retirement Survey (SERS), Summary of Findings* 3 available at <http://www.ebri.org/sers/2002/02sersof.pdf> (last visited Sept. 6, 2002).

61. *The 2002 Small Employer Retirement Survey (SERS), Summary of Findings* 6 available at <http://www.ebri.org/sers/2002/serssummary.pdf> (last visited Sept. 6, 2002).

62. Other employee benefit nondiscrimination tests use slightly different terms, which are defined differently, e.g., 26 U.S.C. §§ 105(h)(5) and 125(e) (2000).

63. See 26 U.S.C. § 416(i) (2000).

64. 26 U.S.C. §§ 125(b)(2), 79(d), 416(i) (2000).

65. See, e.g., 26 U.S.C. §§ 401(a)(9)(C)(ii), 127(b)(3), and 129(d)(4) (2000).

purposes of any special rules applying to owners. 1% owner status would be relevant for top-heavy purposes. All other owner-related terms and their definitions would be repealed.

2. The section 414(q) definition of HCE would apply for purposes of the nondiscrimination requirements applicable to any tax-favored employee benefit. Any other terms or definitions for highly compensated status would be eliminated.⁶⁶

The author supports this proposal. 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 reducing employer flexibility or participant security in any significant way.

One further change is also important: if the top-heavy plan rules⁶⁷ are retained, all references in the top-heavy rules to "key employees" should be replaced by references to highly compensated employees. The preference would be to repeal the top-heavy rules completely,⁶⁸ as they cause considerable additional complexity in both the law and plan administration, while conferring little additional benefit on plan participants. For most employers, the key employee group and the HCE 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.

Finally, there is an underlying problem, which may be more difficult to address effectively. Who are employees for retirement plan purposes? As Douglas Ell points out:

Many companies have hundreds, or even thousands, of contractual arrangements for services. . . . The general standard of present law is that a worker is considered an "employee" if the business retains the right to control the manner in which services are performed. This standard evokes images of factory work a hundred years ago. It is not easy to apply to a large enterprise, with hundreds or thousands of subcontractors and suppliers, and a variety of professionals working in different roles. Vague concepts of "employee" create enormous problems in administering the nondiscrimination and coverage rules.⁶⁹

This issue is important for several reasons: under the exclusive benefit rule, a qualified plan may only cover employees and self-

66. JCT Study, at 191.

67. See generally 26 U.S.C. § 416 (2000) (codifying special rules for top-heavy plans).

68. See generally section III. D *infra*.

69. Douglas Ell, Perspective – *The "Perfect" Retirement Plan*, 12 BEN. L.J. 45, 46 (1999).

employed individuals who are treated as employees;⁷⁰ ERISA covers plans for employees;⁷¹ and the employee coverage and nondiscrimination tests can only be performed correctly if the employer can identify the employees (and leased employees)⁷² who must be included. Some usable guidance on this topic, even if limited to retirement plan issues, would be very helpful.

G. Contribution Limits for Tax-Sheltered Annuities

Before 2002, contributions to a tax sheltered annuity arrangement described in Code section 403(b) were limited, *inter alia*, by the “maximum exclusion allowance” (“MEA”), a complex limitation that applied only to 403(b) plans. The JCT Study recommends that the contribution limits for 403(b) plans should be conformed to the limits for qualified plans by repealing the MEA.⁷³ EGTRRA has since repealed the MEA for tax years beginning after 2001.⁷⁴

However, even after EGTRRA, there are other significant differences between 403(b) plans and qualified plans that should be removed, as they add complexity and do not further an apparent policy objective. First, in the case of a 403(b) plan, a participant’s compensation for purposes of the statutory limitations on contributions and benefits⁷⁵ will be his or her “includible compensation.”⁷⁶ In the case of a qualified plan (including a qualified plan maintained by an employer that is eligible to sponsor a 403(b) plan), a different definition of compensation is used.⁷⁷ 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 MEA rules, as the determination of “includible compensation” is considerably more difficult than the determination of 415 compensation, particularly for a part-time employee. The qualified plan definition should be extended to 403(b) plans.

Second, for section 415 purposes, 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 required control.⁷⁸ This effectively reinstates a rule that was previously

70. 26 U.S.C. §§ 401(a), (c)(1) (2000).

71. ERISA §§ 3(1), 3(2) (2000), 29 U.S.C. §§ 1002(1), 1002(2) (2000). The ERISA definition of employee is spectacularly unhelpful: “The term ‘employee’ means any individual employed by an employer.” 29 U.S.C. § 1002(6) (2000).

72. 26 U.S.C. § 414(n) (2000).

73. JCT Study, at 193.

74. 26 U.S.C. § 403(b) (2000).

75. 26 U.S.C. § 415 (2000).

76. 26 U.S.C. § 403(b)(3) (2000).

77. 26 U.S.C. § 415(c)(3) (2000).

78. 26 U.S.C. § 415(k)(4) (2000), as amended by § 632(b)(1) of EGTRRA (2001). Control is determined under 26 U.S.C. § 414(b) or (c) (2000), as modified by § 415(h) (2000).

contained in the regulations⁷⁹ under the now-repealed Code section 415(e).

Consider the following hypothetical example that illustrates this concept. Two physicians, A and B, are employed by a tax-exempt hospital. They have no ownership interest in, and do not control, the hospital. Each also maintains a separate medical practice of which each is the 100% owner. The hospital and the practice do not constitute an affiliated service group. Physician A participates in the hospital's qualified plan and also in his practice's qualified plan. Benefits under his two plans are *not* aggregated for 415 purposes. However, physician B participates in the hospital's 403(b) plan and also in her practice's qualified plan. Benefits under her two plans *are* aggregated for 415 purposes. This difference cannot be justified.

Third, the dollar limits on elective deferrals are generally the same for a 403(b) plan as for a 401(k) plan.⁸⁰ However, Code § 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. This special rule should be repealed.

Finally, elective deferrals under a 401(k) plan must satisfy either a special nondiscrimination test (the ADP test) under section 401(k)(3) or a design-based safe harbor under section 401(k)(12). Elective deferrals under a 403(b) plan must generally be available to all employees,⁸¹ but the actual deferrals are not tested for discrimination.

Most of the differences between the rules for 403(b) plans and those for 401(k) plans result from a perception that was once true, but is 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, 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 simple, if they ever were, and the differences between the 401(a) and 403(b) rules are a trap for the unwary. Considerable simplification could be achieved by the outright repeal of section 403(b).

Assuming that repeal does not occur in the near future, the repeal of the MEA calculation is laudable. However, the rules for 403(b) plans (including the section 415 rules for 403(b) plans) should,

79. Treas. Reg. § 1.415-7(h) (2000).

80. 26 U.S.C. § 402(g) (2000).

81. 26 U.S.C. § 403(b)(12) (2000).

wherever possible, be the same as those for qualified plans. The special rule illustrated by the example should be repealed. In EGTRRA, Congress repealed the special elections under Code § 415(c)(4) that allowed certain 403(b) plan participants a higher section 415 limit than would otherwise have been permitted. The same policy reasons underlying this change also dictate the repeal of the higher elective deferral limit for certain 403(b) plan participants. Finally, if discrimination testing is appropriate for elective deferrals under a 401(k) plan (including a 401(k) plan maintained by a tax-exempt employer), then it is appropriate for elective deferrals under a 403(b) plan.

H. Minimum Distribution Rules⁸²

The Code requires retirement plan participants, IRA owners and their beneficiaries to begin receiving distributions, generally at age 70½.⁸³ The statute leaves most of the detail to be provided by regulations. In 1987, the IRS issued complex proposed regulations, which were never finalized. On April 16, 2002, the IRS issued final regulations,⁸⁴ which simplify the rules and will almost always reduce the required distribution amounts.

The JCT Study recommends that the minimum distribution rules be simplified to provide that:

1. No distributions are required during the life of the participant;

82. See, e.g., Natalie Choate, *Understanding the Final Minimum Distribution Rules*, available at http://www.ataxplan.com/articles_fr/summary_framp.ntm (last visited Sept. 6, 2002); David A. Pratt, *The Minimum Distribution Regulations*, J. PENSION BEN. (forthcoming, Fall 2002). For articles written before the 2001 and 2002 regulations were issued, see Mark J. Warshawsky, *Minimum Distribution Requirements: Reform or Remove Them*, TAX NOTES, Sept. 30, 1998, at 1133 (describing the rules as “increasingly outmoded in today’s labor market and social conditions”). See also David A. Pratt & Diane Bennett, *Simplifying Retirement Plan Distributions*, 57 NEW YORK UNIVERSITY 57TH INSTITUTE ON FEDERAL TAXATION, EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION, at ch. 5-1 (1999) (recommending that no minimum distributions be required during the lifetime of the plan participant (or IRA owner) and, if he or she is the beneficiary, the surviving spouse, but that the entire benefit should be fully distributed on the death of the survivor of them). See also Jay A. Soled & Bruce A. Wolk, *The Minimum Distribution Rules and Their Critical Role in Controlling the Floodgates of Qualified Plan Wealth*, 2000 BYU L. REV. 587, 617-19 (2000) (recommending that “joint life expectancy should be used only if the designated beneficiary is the spouse” and that “[a]ccounts must be distributed within the year following the participant’s (and spouse’s) death.”).

83. 26 U.S.C. §§ 401(a)(9), 403(a)(1), 403(b)(10), 404(a)(2), 408(a)(6), 408(b)(3), 457(d) (2000).

84. 67 Fed. Reg. 18,988 (April 17, 2000). 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. “For determining required minimum distributions for calendar year 2002, taxpayers may rely on these final regulations, the 2001 proposed regulations, or the 1987 proposed regulations.” 67 Fed. Reg. 18,988, 18,994.

2. If distributions commence during the participant's lifetime under an annuity form of distribution, the terms of the annuity will govern distributions after the participant's death;
3. If distributions either do not commence during the participant's lifetime, or commence during lifetime under a non-annuity form of distribution, the undistributed benefit must be distributed to the participant's beneficiaries within 5 years after the participant's death. As under current law, if the surviving spouse is the beneficiary, he or she would be allowed to effect a rollover.⁸⁵

The JCT proposal represents a significant improvement over the current rules. The new regulations, though significantly less complex than the 1987 proposed regulations, are still very difficult to work with, even for participants and beneficiaries who have access to expert advice. The three most pernicious aspects of the rules are that they apply even to very small retirement benefits, are replete with traps for the unwary,⁸⁶ and carry a confiscatory penalty for failure to withdraw the required amount: an excise tax equal to 50% of the shortfall.⁸⁷

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.⁸⁸ Thus, the IRS has applied an incidental death benefit test⁸⁹ for many years. The previous estate tax exclusions⁹⁰ have been repealed, and the minimum distribution rules have been extended to all tax-favored retirement plans in 1986.

In light of this policy, the plan participant and his or her spouse should have considerable flexibility with respect to payments made while either of them is alive. Accordingly, no distributions should be required during the lifetime of the plan participant, which would have

85. JCT Study, at 196.

86. See generally LYNN ASINOF, *Oops. . . How a Variety of Basic Foul-Ups Are Bedeviling the Beneficiaries of IRAs*, WALL ST. J., March 29, 1999, at C1 (noting that distribution structures of most modern IRAs are "complicated and irrevocable").

87. 26 U.S.C. § 4974 (2000), which applies to qualified plans, § 403(b) plans, IRAs and § 457(b) plans.

88. "Uniform minimum distribution rules which establish the permissible periods over which benefits from any tax-favored retirement arrangement may be distributed ensure that plans are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's pre-retirement income stream at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan." STAFF OF THE JOINT COMMITTEE ON TAXATION, 99th Cong., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 710 (Comm. Print 1987).

89. Treas. Reg. § 1.401-1(b)(1)(i) (2000).

90. 26 U.S.C. §§ 2039(c), (f) (2000).

the additional benefit of bringing the rules into conformity with the rules for Roth IRAs. In order to satisfy the minimum distribution rules, the present temporary regulations require that annuity distributions either be non-increasing, or increase only as specifically permitted by the regulations.⁹¹ This is unduly restrictive: subject to satisfaction of applicable qualification rules (e.g., the definitely determinable benefits rule), there should be few, if any, restrictions on the amounts distributed during the lives of the participant and his or her spouse. It may well be appropriate for payments to increase, for instance to protect the participant and spouse against post-retirement inflation or because the participant is still working part-time when payments begin.

It is also appropriate that, if distributions commence during the participant's lifetime under an annuity form of distribution, the terms of the annuity should govern distributions after the participant's death. The JCT Study does not state specifically whether the annuity must be purchased from an insurance company: this should not be required in the case of a defined benefit plan. Further, if the only survivor annuitant is the surviving spouse, there should be few, if any, restrictions on payments increasing or decreasing after the death of the participant or IRA owner.

The third JCT proposal, that any undistributed benefit must be distributed within 5 years after the participant's death, solves the biggest policy problem under the current rules, the fact that payments can continue for 70 or 80 years after the participant's death if the designated beneficiary is very young.⁹² As under current law, if the surviving spouse is the beneficiary, he or she would be allowed to affect a rollover. The balance in the spousal rollover IRA would be subject to these rules at the death of the spouse.

There may need to be special rules for a narrowly defined class of beneficiaries with disabilities, similar to the special rules governing supplemental needs trusts. Under the 1987 and 2001 proposed regulations, if distributions from a defined benefit plan are not in the form of an annuity, the benefit will be treated as an individual account for purposes of determining the minimum distribution.⁹³ However, the regulations provide no guidance as to how the "account balance" is determined in this situation. Presumably it is the present value of the participant's accrued benefit, but how is that present value calculated?⁹⁴ Another issue on which there appears to be no

91. Temp. Treas. Reg. § 1.401(a)(9)-6T (2000).

92. For instance, assume that a decedent names her five year-old grandson as the designated beneficiary of her IRA, which is worth \$1 million at her death. The current rules allow the IRA to be paid out over the grandchild's life expectancy, 77.7 years. With an 8% annual return, the total payments, if the grandchild takes only the required minimum each year, would be more than \$800 million. This is patently absurd.

93. See Prop. Treas. Reg. § 1.401(a)(9)-6 (2000) (citing Q & A 1(e)).

94. The new temporary regulations issued in April, 2002, would repeal this rule,

formal guidance is this: if a defined benefit plan makes required minimum distributions, in non-annuity form, how does this effect the maximum amount which may be distributed subsequently, in a lump sum, under section 415?

The minimum distribution rules are really aimed at a relatively small group: those people who have large enough assets that they do not need to use all of the income for current living expenses. In light of this, much simplification, and possible hardships, could be avoided by limiting the minimum distribution rules to individuals whose total retirement asset value exceeds a certain threshold, such as \$250,000.

Finally, the 50% penalty tax must be addressed. The only real justification for this confiscatory penalty is that, for the IRS, policing the minimum distribution rules was almost impossible, so that a heavy penalty was required to ensure compliance. The IRS has already introduced reporting requirements for IRAs,⁹⁵ and it should impose similar requirements on qualified plans, 403(b) plans and 457 plans. The 50% penalty should be reduced to no more than 10%.

I. The Early Withdrawal Tax

The primary purpose of the tax subsidy for qualified plans is to encourage individuals to save for their retirement. An important aspect of this policy is to attempt to ensure that funds contributed to a retirement plan continue to be held in a retirement plan until the individual retires, rather than being used for current consumption.⁹⁶

Title 26 U.S.C. § 72(t) (2002) imposes a 10% additional income tax on distributions from retirement plans (including IRAs) that (i) are includible in gross income and (ii) are 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

but it remains in effect at least through 2002, and may well be reinstated when the regulations are finalized.

95. IRS Notice 2002-27, 2002-18 I.R.B. 814.

96. This issue is discussed in detail in a recent report from the United States Department of Labor's ERISA Advisory Council. UNITED STATES DEPARTMENT OF LABOR ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFITS, *Report of the Working Group on Retirement Plan Leakage: "Are We Cashing Out Our Future?"*, 3 (Comm. Print 1998) (the "Advisory Council Report"). The report states:

[T]he statistics, however, show that most Americans spend their retirement savings far in advance of retirement. The most recent Current Population Survey determined that only 20 percent of individuals who received lump sum distributions rolled the entire sum into another tax-qualified vehicle. Leakage from retirement plans is a serious threat. Popular notions of the dangers of participant loans and hardship withdrawals are overstated. The real culprit is the temptation to spend lump sum distributions, particularly smaller distributions and distributions made at an early age.

Id.

a 403(b) plan that are funded with mutual funds, rather than with annuity contracts, may only be distributed if a distribution event has occurred. One distribution event is attainment of age 59½.

The JCT Study recommends that:

1. The exceptions to the early withdrawal tax under Code section 72(t) should be uniform for all tax-favored retirement plans. This would affect 3 exceptions currently available only for IRAs (first time homebuyer expenses, educational expenses, and health insurance expenses of the unemployed) and one that currently applies only to qualified plans (separation from service at or after age 55). Uniformity could be achieved either by extending the exceptions to all plans or by repealing the exceptions: the JCT concluded that the former approach would be more consistent with the policy decisions made by Congress.⁹⁷
2. The applicable age for the early withdrawal tax should be changed from 59½ to 55.⁹⁸ These changes would improve the rules, but they do not go far enough. Section 72(t) is a mess, largely because there are now 15 separate statutory exceptions, several of which (such as the exception for deductible medical expenses) are essentially useless and at least one of which (the exception for substantially equal payments) is used almost exclusively by wealthier individuals.

I recommend the following changes. First, the only exceptions should be those for death and disability, and for distributions that are actually and irrevocably annuitized. Second, age 59½ should be changed to age 55, a common early retirement age under employer plans. Third, 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 disproportionately affect lower income plan participants, including some who have immediate needs for which they must use the money. A better approach is 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: this would eliminate the SEP and SIMPLE IRA withdrawal problem. The penalty for noncompliance would be a substantial penalty tax.

J. 401(k) Plans for Governmental Employers

Most state and local government employers are prohibited from maintaining a 401(k) plan, subject to an exception for certain grand-

97. JCT Study, at 199-201.

98. *Id.*

fathered plans.⁹⁹ The JCT Study recommends that all state and local governments should be permitted to maintain 401(k) plans.¹⁰⁰ The current rule makes absolutely no sense, and this change should be made. Unfortunately, by enacting additional tax advantages for governmental 457 plans in EGTRRA, Congress appears to have taken a different tack. I suggest that it would be greatly preferable, for both policy and simplification reasons, to allow governmental employers to sponsor 401(k) plans. We should then examine whether there were any adequate justifications for continuing to allow governmental 457 plans.

K. Section 457 Plans

As originally enacted, Code section 457 applied only to deferred compensation plans of governmental employers. TRA 86 extended its application to deferred compensation plans of private tax-exempt employers other than churches. Subsequent legislation (including major changes enacted by EGTRRA) has resulted in section 457 (i) being very complex and (ii) including rules that differ significantly for private and public sector employers. As the JCT Study notes:

Despite the differences between section 457 plans maintained by State and local governments and plans maintained by tax-exempt organizations, the same Code provision deals with both types of plans. This causes drafting complexity in that employers and practitioners must review all the rules under section 457 in order to determine those that apply to its plan.¹⁰¹

The JCT Study recommends 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.¹⁰² The need for such a redrafting has become more pressing as a result of the major changes to section 457, particularly for governmental 457 plans, enacted by EGTRRA. However if, as recommended above, governmental employers are again allowed to maintain 401(k) plans, is there still a need for governmental 457 plans?

As a practical matter, because of ERISA, participation in private sector 457 plans is limited to a select group of management or highly compensated employees. By contrast, governmental 457 plans are generally available to all employees of the sponsoring employer, and many of them, such as the New York State Deferred Compensation Plan, have billions of dollars in assets. Governmental 457 plans must now be funded.¹⁰³ EGTRRA has further reduced the differences between governmental 457 plans and governmental qualified plans,

99. 26 U.S.C. § 401(k)(4)(B) (2000).

100. JCT Study, at 202.

101. *Id.* at 204.

102. *Id.*

103. 26 U.S.C. § 457(g) (2000).

for instance by allowing rollovers.¹⁰⁴ Accordingly, we should consider whether section 457 should be repealed with respect to governmental employers, by making existing governmental 457 plans subject to the same rules as apply to governmental qualified plans. We should also consider whether, and the extent to which, the discrepancies between the 457 rules and the qualified plan rules can be justified. As amended by EGTRRA, the rules for governmental 457 plans result in an uneasy hybrid, with some features of a qualified plan and some features of a nonqualified plan, that are difficult to justify from a policy perspective.

The application of section 457 to private tax-exempt employers should also be reviewed, in the light of experience since the section was enacted in 1978. The stated rationale for enactment of more stringent rules governing nonqualified deferred compensation in tax-exempt organizations than in taxable organizations is that, for a taxable employer, the deferral of the tax deduction for nonqualified deferred compensation (as compared to the immediate deduction for current salary or a contribution to a qualified plan) is a deterrent to providing overly generous deferred compensation programs. Recent experience with executive compensation in the private sector suggests that this premise is flawed. In addition, since Congress extended section 457 to private sector tax-exempts in 1986, Congress has enacted the intermediate sanctions rules, which impose significant new restrictions on compensation for executives of tax-exempt organizations.¹⁰⁵ There are at least two reasons for reconsidering the application of section 457 to these private organizations: first, it may not be necessary, because of the new intermediate sanction rules; second, it puts tax-exempt employers (such as hospitals) at an unfair disadvantage in competing for executives with taxable employers. If Code Section 457 is retained, for governmental employers and/or private tax-exempt employers, then its scope, and the scope of the exceptions to its application, must be clarified as soon as possible. The recent proposed regulations,¹⁰⁶ though comprehensive in most respects, do not address these areas. Section 457 includes a crazy quilt of special rules relating to (1) "bona fide" vacation leave, sick leave, compensatory time, severance pay, disability pay and death benefit plans (these terms are not defined in any way)¹⁰⁷ and (2) length of service awards for volunteers.¹⁰⁸ Clarification of these rules is long overdue.

104. JOINT COMMITTEE ON TAXATION, *Present Law and Background Relating to Employer-Sponsored Defined Contribution Plans and Other Retirement Arrangements and Proposals Regarding Defined Contribution Plans* (Comm. Print 2002), reprinted in 2002 Bureau of National Affairs, Inc., DAILY TAX REPORT 39 DTR L-1 (2002).

105. 26 U.S.C. § 4958 (2000).

106. 67 Fed. Reg. 3,0826, May 8, 2002.

107. 26 U.S.C. § 457(e)(11)(A) (2000).

108. *Id.* at §§ 457(e)(11)(B), (C) (2000).

L. Uniform Ownership Attribution Rules

Under the qualified plan rules, different ownership attribution rules apply for different purposes. For example, the Code section 1563 rules are used in determining controlled group status,¹⁰⁹ but the section 318 rules are used to determine whether someone is a 5% owner under the top-heavy rules.¹¹⁰ The JCT Study recommends:

1. that the attribution rules used in determining controlled group status under Code section 1563 should be used in determining ownership for all qualified plan purposes,¹¹¹ and
2. the use of a uniform definition of family members in applying ownership attribution rules for all Code purposes, including the qualified plan rules.¹¹²

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.

M. Basis Recovery Rules

Under current law, there are different basis recovery rules for qualified plans IRAs and Roth IRAs.¹¹³ The JCT Study recommends a uniform basis recovery rule. Distributions would be attributable to basis first, and thus not taxable, until the entire basis has been recovered.¹¹⁴

The proposal should be implemented. Despite some recent simplifications,¹¹⁵ the calculation of the portion of each distribution that is attributable to 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 vehicles, particularly given the greatly relaxed rollover rules under EGTRRA.

The JCT Study also recommends that Code section 72 be redrafted to improve readability.¹¹⁶ This change is long overdue. Code section 72 is entitled "Annuities; certain proceeds of endowment and life insurance contracts." However, in addition to governing the income taxation of insurance products, section 72 governs the taxation of most distributions from qualified plans and IRAs, determines when

109. *Id.* at § 414(b) (2000).

110. *Id.* at § 416(i)(1)(B) (2000).

111. JCT Study, at 209.

112. *Id.* at 253.

113. 26 U.S.C. §§ 72(d), 408(d)(2), 408A(d)(4) (2000).

114. JCT Study, at 220.

115. For example, the enactment of the simplified method of taxing annuity payments from a qualified plan. 26 U.S.C. § 72(d)(1) (2000).

116. JCT Study, at 362.

plan loans are treated as distributions,¹¹⁷ and provides a 10% additional income tax for most distributions made before age 59½ from retirement plans and IRAs.¹¹⁸ As a result, section 72 is lengthy and convoluted.

The JCT Study recommends that the provisions of section 72 that apply to qualified plans should be separated from section 72 and combined with the other rules governing the taxation of distributions from such plans.¹¹⁹ It is highly unsatisfactory that the primary Code 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. All provisions relating to retirement plans should be included in a revised section 402, and the revised section 402 should include cross-references to other Code sections that govern the taxation of retirement arrangements other than qualified plans, such as IRAs and Roth IRAs.

III. SIMPLIFICATION PROPOSALS NOT DISCUSSED IN THE JCT STUDY

A. *Reduce The Number of Different Types of Defined Contribution Plan*

Under current law, an employer wishing to sponsor a qualified 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);
- a stock bonus plan, or an ESOP (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), the employer may adopt:
 - a simplified employee pension plan (SEP);¹²⁰
 - an employer-sponsored IRA;¹²¹
 - a tax-sheltered annuity program, if eligible;¹²²

117. 26 U.S.C. § 72(p) (2000).

118. 26 U.S.C. § 72(t) (2000).

119. JCT Study, at 362.

120. 26 U.S.C. § 408(k) (2000).

121. 26 U.S.C. § 408(c) (2000).

- a 457 plan; or
- a SIMPLE IRA.¹²³

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.¹²⁴

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.¹²⁵

The ability of a tax-exempt employer to adopt a 401(k) plan has eliminated the need for 403(b) plans. The best approach would be to repeal section 403(b). If this is not politically possible, then the fallback position would be to harmonize the rules for 401(k) plans and 403(b) plans to eliminate the ludicrous and indefensible differences that exist under current law.

Similarly, there is no longer any real justification for having different rules for money purchase (including target benefit) plans and profit-sharing plans. The differences result from the pre-ERISA classification of the former as pension plans, and the differences are no longer appropriate: beginning in 2002, there is no longer even a different deduction limitation.¹²⁶ Pamela Perun and Eugene Steuerle have recommended:

[t]he creation of a single, standard form of defined contribution plan. It would replace the multiple plan types now available as well as the separate, "simplified," set of plans for small employers. Such a plan is feasible because, now that contributions to profit-sharing plans no longer depend on employer profits, the historical rationale for maintaining separate money purchase, stock bonus and profit-sharing plans no longer exists. The principle [sic] remaining differences among the plans are whether the formula is fixed or discretionary, what spousal rights attach to benefits, what limit on deductible contributions

122. 26 U.S.C. § 403(b) (2000).

123. 26 U.S.C. § 408(p) (2000).

124. Gene Steuerle asks:

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.

Gene Steuerle, *Why Pension Simplification Is So Difficult to Achieve*, 80 TAX NOTES 253 (1998).

125. PENSION AND WELFARE BENEFITS ADMINISTRATION OFFICE OF POLICY RESEARCH, PRIVATE PENSION PLAN BULLETIN, *Abstract of 1996 Form 5500 Annual Reports*, no.9, (Winter 1999-2000).

126. 26 U.S.C. § 404(a) (2000).

should apply, and how benefits may be distributed, that is, in cash or in stock. These are not difficult design issues. It should be relatively easy to compromise on a standard form of plan with sufficient flexibility to be attractive to small and large employers alike.¹²⁷

B. Minimum Funding Rules

One of the primary goals of ERISA was to improve the funding of defined benefit plans.¹²⁸ Accordingly, ERISA enacted minimum funding rules.¹²⁹ If the employer fails to contribute to the plan an amount at least equal to the required minimum, it becomes subject to a 10% first tier excise tax and, unless the under-funding is corrected, a 100% second tier excise tax.¹³⁰

Profit-sharing plans, 401(k) plans, stock bonus plans, and ESOPs are generally not subject to any minimum funding rules (if a cash or deferred arrangement (CODA) 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). By contrast, money purchase pension plans (including target benefit plans) are subject to the minimum funding rules.¹³¹

The minimum funding requirements should apply only to defined benefit plans. Consider the following plan designs:

1. The 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 CODA.

In each case, the employer has made a contractual commitment to contribute to the plan, that commitment is not contingent upon

127. PAMELA PERUN & C. EUGENE STEUERLE, *ERISA at 50: A Model for the Private Pension System*, ALI-ABA PENSION POLICY CONFERENCE: ERISA AFTER 25 YEARS, Oct. 1, 1999.

128. Congress found that "owing to the inadequacy of current minimum standards, the soundness and stability of plans with respect to adequate funds to pay promised benefits may be endangered." 29 U.S.C. § 1001(a) (2000).

129. 26 U.S.C. § 412 (2000); 29 U.S.C. §§ 1081 *et seq.* (2000). The deadline for making the contribution for a plan year is 8 ½ months after the end of the plan year. 26 U.S.C. § 412(c)(10) (2000); Treas. Reg. § 11.412(c)-12 (2000). If the employer is even one day late, the full excise tax is payable. This deadline is not always the same as the deadline for making deductible contributions. 26 U.S.C. § 404(a)(6) (2000).

130. 26 U.S.C. § 4971 (2000).

131. 26 U.S.C. § 412 (2000); 29 U.S.C. 1082 (2000).

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 numbers two and three 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.

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.

The funding rules of section 412 have been tinkered with so much since the enactment of ERISA that the section is almost impossible to read. Consideration should be given to simplifying the rules, as many of the mid-stream changes have added more complexity than they are worth. A good start would be to eliminate the section 412(l) deficit reduction contribution and replace it with shorter amortization periods.

C. Discrimination Rules for Elective Deferrals

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.¹³² However, elective deferrals under a 403(b) plan are not subject to any discrimination test similar to the actual deferral percentage ("ADP") test¹³³ for elective deferrals under a 401(k) plan. Further, 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.¹³⁴

It has been suggested above that there is no longer any sufficient reason to have 403(b) plans as well as 401(k) plans. If 403(b) plans are to be retained, then the rules should be harmonized with the 401(k) plan rules. As the JCT Study suggests, "further simplification could be achieved by conforming all the rules for the various elective deferral arrangements available to all employers."¹³⁵ The universal availability rule for 403(b) plans 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.

Elective deferrals under a 403(b) plan should be subject to a nondiscrimination test similar to the ADP test for 401(k) plans. Why

132. 26 U.S.C. § 403(b)(12)(A)(ii) (2000).

133. 26 U.S.C. § 401(k)(3) (2000).

134. 26 U.S.C. § 402(g)(7) (2000).

135. JCT Study, at 187.

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 is perfectly acceptable from a policy viewpoint.

There is an argument that this would prove burdensome for small tax-exempts, but it would be no more burdensome than the ADP test is 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.¹³⁶ While this is hardly wealth beyond the dreams of avarice, 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, given that many small business owners earn substantially less than this amount.

D. Top-Heavy Plans

If a plan is top-heavy, because more than 60% of the accumulated benefits under the plan are provided for “key employees,” then the plan is required to provide accelerated vesting and minimum contributions or benefits.¹³⁷ Considerable simplification could be achieved by repealing the top-heavy rules. In a recent report,¹³⁸ the General Accounting Office (GAO) found 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 stated, contrary to the experience of most pension practitioners, that the top-heavy rules impose only slight additional burdens on plans sponsors. The report concluded that

[i]n 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.¹³⁹

The GAO report understates the regulatory burden on all qualified plans resulting from the retention of top-heavy rules which actually affect only a small number of plans, almost all of which are very small.¹⁴⁰ The better view is stated in a 1998 report issued by a

136. 26 U.S.C. § 414(q) (2000).

137. 26 U.S.C. § 416 (2000).

138. *Private Pensions: “Top-Heavy” Rules for Owner-Dominated Plans*, GAO/HEHS-00-141, August, 2000, reprinted in TAX NOTES TODAY, 2000 TNT 193-16, available at <http://www.lexis.com> (last visited Sept. 6, 2002).

139. *Id.*

140. According to the GAO, approximately 84% of all top-heavy plans established

working group of the ERISA Advisory Council,¹⁴¹ 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.¹⁴²

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 the better approach is to tighten those rules, not to retain the top-heavy rules.

The top-heavy rules were simplified somewhat by section 613 of EGTRRA. Assuming that the top-heavy rules are not repealed, further changes are still required. First, the definition of the minimum contribution to a top-heavy defined contribution plan¹⁴³ should be modified by (1) making it identical to the nonelective contribution under a safe harbor 401(k) plan,¹⁴⁴ and (2) repealing the rule¹⁴⁵ that elective deferrals by employees are included in calculating the highest contribution rate for any key employee. Second, as suggested above, considerable simplification would result from replacing references to key employees and non-key employees with references to HCEs and NHCEs.

in 1996, the most recent year for which data were available, had fewer than 10 participants. The GAO reported that:

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.

141. 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/pwba/public/adccoun/smrpt1.htm (last visited Sept. 6, 2002).

142. *Id.*

143. The minimum contribution is defined in 26 U.S.C. § 416(c)(2) (2000).

144. The non-elective employer contribution to a safe harbor 401(k) plan is defined in 26 U.S.C. § 401(k)(12)(C) (2000).

145. This rule is found in 26 U.S.C. § 416(c)(2)(B)(i) (2000), as explained by Question and Answer M-20 in Treas. Reg. § 1.416-1 (2000).

E. Incidental Benefits

Under the pre-ERISA regulations, profit-sharing plans may provide "incidental" life and health insurance benefits.¹⁴⁶ 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.¹⁴⁷ Second-to-die life insurance is permitted in a profit-sharing plan,¹⁴⁸ 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.¹⁴⁹ There appears to be no good reason for the differences summarized above, but then is there really any good reason why qualified plans should be complicated by including ancillary benefits unrelated to the primary purpose of the plan—providing retirement income?¹⁵⁰ Subject to transition rules, incidental health and death benefits should no longer be permitted to be part of a qualified plan. The fall back position is that, if such benefits continue to be permitted, the rules should be uniform for all types of qualified plans.

F. Special Rules for Owner-Employees

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. 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.¹⁵¹

146. Treas. Reg. § 1.401-1(b)(1)(ii) (2000).

147. 26 U.S.C. § 401(h) (2000); Treas. Reg. §§1.401-1(b)(1)(i), -14(c)(1) (2000).

148. Priv. Ltr. Rul. 84-45-095 (Aug. 13, 1984); Treas. Reg. § 1.401-1(b)(1)(ii) (2000).

149. Rev. Rul. 69-523, 1969-2 CB 90.

150. David A. Pratt and Diane Bennett explain:

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 & Bennett, *supra* note 82.

151. 26 U.S.C. § 401(d) (2000).

2. The definition of “earned income” of a self-employed individual does not correspond precisely to the “compensation” used for employees.¹⁵²
3. For a self-employed individual, although separation from service is not, disability is a triggering event for lump sum distribution treatment. For an employee, the reverse is true.¹⁵³
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.¹⁵⁴

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.¹⁵⁵

These few remaining special rules should be repealed. 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). If the definition of “owner-employee” retains any significance, it should be simplified. One possible approach, though it is much less simple than repeal, would be to replace all references to “owner-employees” with references to 5% owners.¹⁵⁶

G. Permissible Investments

As a general rule, a qualified plan has a very broad range of permissible investments, subject to few limitations:

1. The plan and its fiduciaries must comply with the prudence, diversification and prohibited transaction rules, and with any limitations imposed by the plan documents, and must avoid engaging in any “prohibited transaction”.¹⁵⁷
2. There are limitations on the acquisition and holding of employer securities and employer real property.¹⁵⁸ 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.¹⁵⁹ A profit-sharing plan, stock bonus plan or ESOP is an “eligible individual account plan” which can, if the plan so permits, and subject to ERISA fiduciary

152. 26 U.S.C. § 401(c)(2)(A) (2000).

153. 26 U.S.C. § 402(e)(4)(D) (2000).

154. 26 U.S.C. §§ 404(a)(8), (e) (2000).

155. 26 U.S.C. § 401(c)(3) (2000).

156. *See* 26 U.S.C. § 416(i)(1)(B)(i) (2000) (defining ‘5% owner’).

157. 29 U.S.C. §§ 1104(a)(1)(B), (C), (D), 1106 (2000); 26 U.S.C. § 4975 (2000).

158. 29 U.S.C. § 1107 (2000).

159. 29 U.S.C. § 1107(a)(2) (2000). *See also* 29 U.S.C. §§ 1107(d)(5) and (e) (2000). (defining ‘qualifying employer security’).

rules, invest up to 100% of its assets therein.¹⁶⁰

3. The amount invested in life insurance contracts must be limited, so that the death benefit remains "incidental".¹⁶¹
4. Acquisition of a collectible, by an individually directed account, is treated as a taxable distribution.¹⁶²

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).¹⁶³ However, if the plan is a defined contribution program (or a grand-fathered 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,¹⁶⁴ which has all of the investment alternatives available to a qualified plan and, if it is exempt from ERISA (as most church plans are),¹⁶⁵ it 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),¹⁶⁶ and acquisition of a collectible is treated as a taxable distribution.¹⁶⁷

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

The author suggests section 403(b) should be repealed. 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 investments.

H. Prohibited Transactions

Retirement plans are subject to extensive prohibited transaction

160. 29 U.S.C. §§ 1107(b), (d)(3)(A) (2000). Certain pre-ERISA money purchase plans also qualify as eligible individual account plans 29 U.S.C. § 1107(d)(3)(A) (2000).

161. Treas. Reg. § 1.401-1(b)(1)(i), (ii) (2000).

162. 26 U.S.C. § 408(m) (2000).

163. 26 U.S.C. §§ 403(b)(1), (7) (2000).

164. 26 U.S.C. § 403(b)(9) (2000).

165. See ERISA § 4(b)(2) (2000), (describing exemption of church plans from coverage under ERISA; the term "church plan" is defined in ERISA § 3(33) (2000)).

166. 26 U.S.C. §§ 408(a)(3), (e)(2) (2000).

167. 26 U.S.C. § 408(m) (2000).

rules under both the Code and ERISA.¹⁶⁸ The prohibition is categorical, and does not depend on any finding that the transaction is inappropriate or unfair to the plan. For instance, an employer is generally not allowed to contribute publicly traded securities (even if unencumbered) to a pension plan, even though there would be little or no risk to the plan.

There is an extensive and complex set of statutory and regulatory exemptions.¹⁶⁹ It is also possible for a fiduciary to apply to DOL for an individual exemption.¹⁷⁰

Violation of these rules, even if inadvertent, can result in enormous penalties. The Code imposes a first tier excise tax equal to 15% of the amount involved in the transaction.¹⁷¹ If the transaction is not corrected, then there is a second tier excise tax equal to 100% of the amount involved.¹⁷² In *Comm'r v Keystone Consolidated Indus., Inc.*,¹⁷³ the IRS assessed almost \$13 million in excise taxes.¹⁷⁴ In *Zabolotny v. Comm'r*,¹⁷⁵ the total assessment was over \$8 million.¹⁷⁶ In the absence of proof of willful malfeasance, these penalties seem grossly disproportionate, and are likely to affect the employer's ability and willingness to continue to fund the plan.

The breadth of the rules is illustrated by the Supreme Court's recent decision in *Harris Trust and Sav. Bank v Salomon Smith Barney, Inc.*¹⁷⁷ Salomon provided broker-dealer services to the plaintiff pension plan by executing non-discretionary equity trades at the direction of the plan's fiduciaries. Salomon was not a fiduciary but, as a service provider, was automatically classified as a party in interest with respect to the plan. During the same period, in transactions totally unrelated to its role as broker-dealer, Salomon sold to the plan interests in several motel properties for about \$21 million: these investments were directed by the plan's investment manager. The plaintiffs discovered that the motel interests were nearly worthless, and claimed that they had been worthless all along. As the motel transactions were between the plan and a party in interest, the Court assumed that the transactions were prohibited by ERISA and, on that assumption, held that the Trustee of the plan could sue Salomon, as a non-fiduciary party in interest to a prohibited transaction, for restitution under section 502(a)(3) of ERISA.¹⁷⁸

There is also doubt as to whether the prohibited transaction

168. 26 U.S.C. § 4975; ERISA § 406 (2000).

169. 26 U.S.C. §§ 4975(c)(2), (d) (2000); ERISA § 408 (2000).

170. *Id.*

171. 26 U.S.C. § 4975(a) (2000).

172. 26 U.S.C. § 4975(b) (2000).

173. 508 U.S. 152, 156 (1993).

174. *Id.* at 156.

175. 7 F.3d 774, 775 (8th Cir. 1993).

176. *Id.* at 775.

177. 530 U.S. 238 (2000).

178. *Id.* at 241.

rules actually provide any real protection to employees:

Several experienced ERISA attorneys were recently asked if they were aware of any case in which these rules had prevented or punished some abusive act that was not also proscribed by the general fiduciary rules. None could identify a single case. If there are any such cases, the DOL should identify them so that it would be possible to weigh the beneficial value against the easily identifiable cost these rules exact.¹⁷⁹

Congress should require the Treasury Department, the IRS and the DOL to conduct a comprehensive study, involving public input, to report to Congress on limiting the scope of the present rules and clarifying those that remain in effect. Although 27 years have passed since ERISA was enacted, the precise scope of some of the prohibitions and exemptions is still not clear, introducing undesirable uncertainty into plan administration and conferring too much power on DOL, the agency responsible for enforcing the rules. A comprehensive review of these rules is long overdue. In addition, the exemption process should be made quicker and more efficient.¹⁸⁰ The prohibited transaction rules also apply to IRAs, though their application to IRAs is often difficult to analyze. In addition, if an IRA is involved in a prohibited transaction, the sanction is extremely severe: the entire value of the account becomes immediately taxable.¹⁸¹ The prohibitions are so broad that it would be impossible to operate any plan without the network of exemptions.¹⁸²

The study should also consider whether any prohibited transaction rules are appropriate for retirement arrangements that do not involve an employer, i.e., most regular, rollover and Roth IRAs. Also, to the extent that the rules continue to apply to IRAs, the sanction for a prohibited transaction by an IRA should be made more reasonable.

I. Payment of Benefits

Pension plans (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.¹⁸³ A

179. Kathleen P. Utgoff & Theodore R. Groom, *The Regulation of Pensions: Twenty Questions After Twenty Years*, 21 J. PENSION PLANNING & COMPLIANCE 1, 13 (1995).

180. See Department of Labor, Office of the Inspector General, Evaluation of PWBA's "Prohibited Transactions" Exemptions Process, Report No. 2E-12-001-0003, September 21, 2000 (describing ways whereby PWBA can improve efficiency in the areas of staffing and information technology), available at <http://www.oig.dol.gov/public/reports/oace/fy2000/2e120010003.pdf> (last visited July 6, 2002).

181. 26 U.S.C. § 408(e)(2) (2000).

182. As Langbein and Wolk have asked, "Ought a regulatory scheme to be so overinclusive that it is unworkable without an extensive law of exemptions?" Langbein & Wolk, *supra* note 28 at 705.

183. Treas. Reg. § 1.401-1(b)(1)(i) (2000); TIR 1403, Q & A M-15; Rev. Rul. 69-

plan may specify that any age less than 65 is the normal retirement age.¹⁸⁴

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 the required matching or non-elective contribution to a safe harbor 401(k) plan) incorporate liberal in-service distribution rules.¹⁸⁵

The rules for 403(b) plans differ, depending on whether the funds are invested in annuity contracts or mutual funds.¹⁸⁶

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.¹⁸⁷ A similar rule applies to SIMPLE IRAs.¹⁸⁸

If the present value of the participant's benefit under a plan exceeds \$5,000, the benefit may not be distributed, prior to the later of age 62 or normal retirement age, without the participant's consent.¹⁸⁹ If the value of the benefit does not exceed \$5,000, the benefit may be distributed without the participant's consent, and without complying with the annuity rules.¹⁹⁰ This rule sends the (wrong) message that these relatively small distributions are not worth bothering about. For many low-income employees, the best they can expect from the pension system may be a series of small payouts each time they change jobs. For instance, if a 30-year old employee receives a \$5,000 cash-out and earns a 9% annual return, it will be worth \$80,000 by the time he or she reaches age 62. According to one report, only 20% of distributions under \$3,500 were rolled over, compared to 95% of distributions over \$100,000.¹⁹¹ Also, the rollover rate was 89% for individuals aged 60 or older, but only 26% for those aged 20-29.¹⁹²

277, 1969-1 C.B. 116; Rev. Rul. 71-24, 1971-1 C.B. 114.

184. Rev. Rul. 78-120, 1978-1 C.B. 117.

185. Treas. Reg. § 1.401-1(b)(1)(ii) (2000); Rev. Rul. 60-323, 1960-2 C.B. 148, modifying Rev. Rul. 56-693, 1956-2 C.B. 282. For the special restrictions, see 26 U.S.C. §§ 401(k)(2)(B) (elective deferrals) and 401(k)(12)(E)(i) (2000) (safe harbor 401(k) plans) and Treas. Reg. § 1.401(k)-1(g)(13)(iii) (2000) (QMACs and QNECs).

186. 26 U.S.C. § 403(b)(7)(A)(ii), (b)(11) (2000).

187. 26 U.S.C. § 408(k)(4) (2000).

188. 26 U.S.C. § 408(p)(3) (2000).

189. 26 U.S.C. § 411(a)(11) (2000), ERISA § 203(e) (2000) (29 U.S.C. § 1053(e) (2000)), Treas. Reg. § 1.411(a)-11(c)(4) (2000).

190. 26 U.S.C. § 417(e) (2000); ERISA § 205(g) (2000) (29 U.S.C. § 1055(g) (2000)). For distributions made on or after January 1, 2000, any benefits attributable to rollovers may be disregarded in determining whether the \$5,000 threshold is exceeded.

191. U.S. DEPARTMENT OF LABOR, ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFITS, Working Group on Retirement Plan Leakage, *Are We Cashing Out Our Future?* November 13, 1998 at 8, (citing the 1996 Hewitt database), available at <http://www.dol.gov/pwba/adccoun/leaknew1.htm> (last visited July 6, 2002).

192. *Id.*

The inability of an employer to restrict withdrawals from a SEP or SIMPLE IRA significantly undermines their effectiveness as retirement savings arrangements. There appears to be no good policy reason for this rule, and it should be repealed.

All retirement plans and IRAs should be subject to a uniform set of distribution rules. The current 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 several 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. It is understandable that Congress wished to restrict the ability of employees to use 401(k) deferrals as short-term savings arrangements but, rather than enacting special restrictions, 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.

Consistent with the recommendations relating to the premature distribution penalty tax,¹⁹³ distributions before a certain age (such as 55) from any type of plan should be strictly limited. After that age, distributions from any type of plan should be available, regardless of whether the participant has terminated employment with the plan sponsor, if the plan so provides.

Modifications to the distribution rules should also reflect the fact that, in an attempt to retain the hard-to-replace skills of older workers, many employers have begun to view retirement as a gradual continuum, during which the employee gradually reduces his or her work time, rather than as a single fixed event. A 1999 Watson Wyatt survey of 586 large employers found that about 16% have formal phased retirement programs, and another 28% are interested in implementing one in the next few years.¹⁹⁴

Among public sector employers, deferred retirement option plans

193. See section II.I, *supra*.

194. *Phased Retirement: Reshaping the End of Work*, available at <http://www.watsonwyatt.com/search/publications.asp?Component=Insider&ArticleID=8376&nm=Watson%20Wyatt> (last visited July 6, 2002). See also ERISA Advisory Council, Working Group Report on Phased Retirement, Nov. 14, 2000, available at <http://www.dol.gov/pwba/adccoun/phasedr1.htm> (last visited July 6, 2002) (discussing the structure of phased retirement plans and the ERISA Advisory Council's recommendations to the Secretary of the DOL).

(DROPs) have become popular. Under the most common version of this option, pension payments commence and are credited to an individual account within the same plan while the employee continues working. After a specified number of years, typically five, the employee retires and receives the monthly pension and the accumulated value (including earnings) of the account, which is generally paid in a lump sum.¹⁹⁵

The value of a participant's pension under a traditional plan will generally decrease, often by a substantial amount, if the participant continues to work after normal retirement age or, if the early retirement benefit is subsidized, after early retirement age. Thus, even employees who do not really want to retire may decide that it would be foolish not to do so. Encouraging employees to work longer may be good for the employer, by keeping in the work force experienced employees who have skills that may not be easily replaced. It is also good for the Social Security system, as the continued employment means that Social Security tax will continue to be paid on the worker's behalf and, at least as long as the worker is under age 65, payment of Social Security benefits will be deferred:

I believe [President Bush's Social Security] Commission should redefine retirement age policy by setting an earliest retirement age and increasing it gradually so that the system stays within budgetary balance taking into account such factors as growth in life expectancy and . . . changes in other demographic factors such as fertility rates. (A reduction in the growth rate of expected lifetime benefits can also be part of this balancing act, but retirement age adjustments require less net benefit reduction because they produce more tax revenue). There should be no "normal retirement age." Instead, there should be a systematic actuarial adjustment in benefits for those who work any period beyond the earliest retirement age.¹⁹⁶

In July, 2000, Rep. Pomeroy and Sen. Grassley introduced the Phased Retirement Liberalization Act, which would have allowed pension payments to be made during employment after the earliest of normal retirement age, age 59 ½, or 30 years of service. This should be revisited, with a view towards moving away from the idea of retirement as a single life-changing event — full-time worker one day, totally retired the next day — to the idea of retirement as a continuum, where the worker reduces his or her hours gradually and has the option of receiving gradually increasing pension payments.¹⁹⁷

195. *Id.* See generally TERRY A.M. MUMFORD & MARY BETH BRAITMAN, *Deferred Retirement Option Programs ("DROPs")*, ALI-ABA COURSE OF STUDY MATERIALS, EMPLOYEE RETIREMENT AND WELFARE PLANS OF TAX-EXEMPT AND GOVERNMENTAL EMPLOYERS, (Course No. SE04, September, 1999); Amy L. Cavanaugh, *A Closer Look at DROP Plans*, 8 J. PENSION BENEFITS 34 (2001).

196. C. Eugene Steuerle, *Major Issues in Social Security Reform. Statement Before the President's Commission to Strengthen Social Security*, October 18, 2001.

197. As Adrien LaBombarde described it:

On June 14, 2002, the IRS and the Treasury Department requested comments on phased retirement arrangements under defined benefit plans, and cited several specific issues on which comments were requested.¹⁹⁸ The Notice stated that:

[a]s people are living longer, healthier lives, it is important to reduce the risk of individuals outliving their retirement savings. Phased retirement can provide employees additional time to save for retirement because employees continue working (while they are healthier and thus able to do so) and can accrue additional benefits and reduce or forgo early spending of their retirement savings. However, phased retirement can also increase the risk of outliving retirement savings for employees who begin drawing upon their retirement savings before normal retirement age. Even though the annuity distribution options offered by defined benefit plans preclude outliving benefits, early distribution of a portion of the participant's benefit will reduce the benefits available after normal retirement age.¹⁹⁹

J. Annuity Rules

A defined benefit or money purchase plan is always subject to the qualified joint and survivor annuity ("QJSA"), and qualified pre-retirement survivor annuity ("QPSA") rules.²⁰⁰ A profit-sharing plan, stock 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.²⁰¹

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.

Any plan that is required to offer the QJSA and QPSA is also required to give the participant a written explanation of the annuity option, including the terms and conditions of the annuity, the

From the perspective of benefits adequacy planning, the level of benefit should be coordinated with the reduced income from partial service with the employer, so that the combined amounts represent a consistent transition between the income during full active service and the retirement income anticipated during full retirement. Full planning of the transition should take all relevant factors into account, including eligibility for active employee benefits, retiree welfare benefits, receipt of Social Security benefits, and the individual's changing needs during the transition.

Adrien R. LaBombarde, *Can Phased Retirement Really Work?* Milliman & Robertson Benefits Perspectives Update, May 2001 at 1; available at http://www.milliman.com/files/PUp_0501_arl_phased.pdf (last visited July 6, 2002).

198. IRS Notice 2002-43, 2002-27 I.R.B. 1.

199. *Id.*

200. 26 U.S.C. §§ 401(a)(11) and 417 (2000), ERISA § 205 (2000).

201. 26 U.S.C. § 401(a)(11)(B)(iii) (2000); ERISA § 205(b)(1)(C) (2000).

participant's right to make, and the effect of, an election to waive the annuity, the spousal consent rules, and the participant's right to make, and the effect of, a revocation of an election to waive the annuity.²⁰²

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: "[s]everal empirical studies show that, unless their property is large enough to entail tax planning, spouses overwhelmingly strain to leave everything to the surviving spouse, commonly disinheriting children in the process."²⁰³ All defined contribution pension plans should be allowed to avoid being subject to the QJSA and QPSA rules by complying with the conditions applicable to profit sharing and stock bonus plans. In addition, these rules should be extended to IRAs.

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.²⁰⁴ 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.

Universally, the anecdotal information indicates that less than one percent of the participants in defined contribution plans with lump sum payments take annuity forms of payment. In some cases, clients can't remember a single participant who has taken an annuity in the last ten years. In defined benefit plans that offer lump sum payments, the number of participants who take annuities is also insignificant — again less than one percent. . . . Anecdotally, it is perceived that perhaps as many as one to three percent of the retirement age participants take an

202. The prevailing view is that a premarital waiver of the QJSA (for example, a prenuptial agreement) is void (*see, e.g.*, *Hurwitz v Sher*, 982 F.2d 778, 782 (2nd Cir. 1992) (citing Treas. Reg. 1.401(a)-20 (2000), Q & A 28 as support for the lower court's holding that a premarital waiver does not satisfy the consent requirements of 26 U.S.C. §§ 401(a)(11) and 417 (2000)). However, one state appellate court has held that a premarital waiver is valid. *In re Estate of Hopkins*, 574 N.E.2d 230, 235-36 (Ill. App. Ct. 1991).

203. Langbein & Wolk, *supra* note 28 at 584 (citing empirical literature collected in Uniform Probate Code § 2-102, Comment (1993 revision)).

204. "For one employer, with a DB-DC floor offset arrangement, the forms are 39 pages: only one participant out of several hundred in the last 5 years did not elect a lump sum from both plans." American Bar Association, Section of Taxation, Employee Benefits Committee: Comments Regarding the Internal Revenue Service and Treasury Department Proposal on Application of Section 411(d)(6) to Defined Contribution Plans (1999) (the "ABA Report") at 16; 1999 TNT 109-15, June 8, 1999.

annuity form of payment — if that many.²⁰⁵

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,²⁰⁶ or pursuant to the regulatory exemption for employee-funded plans,²⁰⁷ 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 another beneficiary.²⁰⁸ 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 can avoid being subject to the QJSA and QPSA rules by complying with the conditions applicable to profit-sharing and stock bonus plans. 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, unless he or she consents to another beneficiary being named.

In addition, it is anomalous, given the increasing utilization of rollover IRAs, 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. Surely the nature and extent of spousal protection should be the same, regardless of the type of retirement arrangement involved. Accordingly, though it does not further simplification, IRAs should be subject to the same (modified) rules as apply to defined contribution plans.

We now have 17 years of experience with the ERISA annuity rules, as modified by the REA. Surely, it should now be possible to simplify the rules. One helpful move would be for the IRS to issue model safe harbor language for the annuity explanation, as it did in 1997 for spousal waivers of the QJSA or QPSA.²⁰⁹

K. Taxation of Distributions

In general, distributions from retirement plans are subject to taxation as ordinary income, except to the extent that they represent a return of basis.²¹⁰ However, if the plan distributes employer

205. *Id.* at 10.

206. ERISA § 4(b)(1), (2) (2000).

207. 29 C.F.R. § 2510.3-2(f) (2000).

208. 29 U.S.C. § 1055(b)(1)(C) (2000).

209. *See generally* I.R.S. Notice 97-10, 1997-1 C.B. 370 (containing sample language for a spouse's waiver to a QJSA or QPSA).

210. 26 U.S.C. §§ 402(a), 403(b)(1), and 457(a)(1) (2000). The constructive receipt rule generally does not apply to tax-favored retirement arrangements, so the fact that the funds could have been distributed sooner is not relevant. However, the

securities, there are special rules for the “net unrealized appreciation.”²¹¹ Also, in the case of a participant born before 1936, certain lump sum distributions from qualified plans qualify for favorable averaging or capital gains treatment.²¹²

Most distributions before age 59½ are subject to a 10% additional income tax.²¹³ This tax applies to 401(k) plans, 403(b) plans and IRAs (including SEPS and SIMPLE IRAs). The tax does not apply to 457 plans of private tax-exempt employers, but does apply to distributions from a governmental 457 plan, to the extent that they are attributable to rollovers to the plan from another type of plan.²¹⁴

The special rules granting favorable tax treatment of lump sum distributions and net unrealized appreciation on employer securities should be repealed. 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.

L. Rollovers

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)²¹⁵ from any

constructive receipt rule does apply to 457 plans maintained by private tax-exempt employers. 26 U.S.C. § 457(a)(1)(B) (2000).

211. 26 U.S.C. § 402(e)(4) (2000).

212. Tax Reform Act of 1986 §§ 1122(h)(3)-(6), as amended by the Technical and Miscellaneous Revenue Act of 1988 §§ 1011A(b)(13), (15) (1988). If the taxpayer receives a “qualified distribution” from a Roth IRA, the distribution is not taxable. See 26 U.S.C. § 408A(d)(2)(A) (2000) (defining “qualified distribution”). See also 26 U.S.C. § 408A(d)(1) (2000) (excluding qualified distribution from a Roth IRA from gross income). Also, if a death benefit consists of or includes life insurance proceeds, then the at-risk portion of the insurance proceeds (total proceeds minus the cash surrender value of the policy immediately before the participant’s death) is not taxable. 26 U.S.C. § 72(m)(3) (2000).

213. 26 U.S.C. § 72(t)(2)(A)(i) (2000).

214. 26 U.S.C. § 72(t)(9) (2000).

215. 26 U.S.C. § 402(c)(4) (2000). Any distribution from a qualified plan is an eligible rollover distribution, except: (1) a “distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made: [(a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee’s designated beneficiary, or [(b) for a fixed period of 10 years or more.” 26 U.S.C. § 402(c)(4)(A) (2000). See also Treas. Reg. § 1.402(c)-2 (2000) (amplifying 26 U.S.C. § 402(c)(4)(A) (2000) in question and answer 5 and 6); (2) a required minimum distribution (RMD) under 26 U.S.C. § 401(a)(9) (2000); 26 U.S.C. § 402(c)(4)(B) (2000) see also Treas. Reg. § 1.402(c)-2 (2000) (discussing § 402(c)(4)(B) in question and answer 7); and (3) a hardship distribution (some hardship distributions made before January 1, 2000, were eligible rollover distributions) 26 U.S.C. § 402(c)(4)(C) (2000). According to Notice 2000-3, 2000-2 I.R.B. 289, a distribution from a governmental 457 plan on account of an unforeseeable emergency cannot be rolled over. Under the regulations, the

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 the surviving spouse of the participant or owner, or by an alternate payee under a qualified domestic relations order (QDRO) who is the spouse or former spouse of the participant.²¹⁶

Unless the distribution is directly rolled over, an eligible rollover distribution is subject to mandatory 20% income tax withholding;²¹⁷ this does not apply to distributions from an IRA.²¹⁸ Distributions from a private sector 457 plan are not eligible for rollover, and thus are not subject to mandatory withholding, but a direct transfer may be made from one 457 plan to another.²¹⁹

If the distribution is made in property other than cash, then the amount so transferred must be the property distributed.²²⁰ Alternatively, part or all of the proceeds from the sale of the property may be rolled over. To the extent that the proceeds are rolled over, no gain or loss will be recognized on the sale.²²¹ There must be an actual sale: if, instead of selling the property received in the distribution, the individual simply contributes cash equal to the fair market value of the property, the cash contribution is not a valid rollover contribution.²²² The rule allowing property distributed by a qualified plan or 403(b) arrangement to be sold, and the proceeds of sale rolled over, does not apply to a distribution from an IRA.²²³

following are also not eligible rollover distributions: (1) corrective distributions of elective deferrals and income, to cure a 26 U.S.C. § 415 violation; (2) corrective distributions of excess deferrals and income, to cure a violation of the annual dollar limitation on elective deferrals (26 U.S.C. §§ 401(a)(30) and 402(g) (2000)); (3) corrective distributions of excess contributions and income or excess aggregate contributions and income, to cure a failure of the ADP test or ACP test; (4) loans that are treated as deemed distributions pursuant to 26 U.S.C. § 72(p) (2000) (by contrast, a loan offset amount may be an eligible rollover distribution) (*see* Treas. Reg. § 1.402(c)-2 (2000) (discussing plan loan offset amount in question and answer 9) and I.R.S. Notice 93-3, 1993-1 C.B. 293); (5) dividends paid on employer securities held by an ESOP, as described in 26 U.S.C. § 404(k) (2000); and (6) the taxable cost of life insurance protection under a qualified plan (the P.S. 58 costs).

216. *See generally* 26 U.S.C. § 402(c)(1) (2000); 26 U.S.C. § 403(b)(8) (2000); 26 U.S.C. § 408(d)(3)(A), (D) (2000); 26 U.S.C. § 457(e)(16)(B) (2000) (regulating rollover amounts).

217. 26 U.S.C. § 3405(c)(1)(B) (2000).

218. The direct rollover requirement applies to qualified plans, and section 403(b) arrangements, but does not apply to IRAs. For distributions made on or after January 1, 2000, the direct rollover requirement also applies to governmental 457 plans. 26 U.S.C. § 401(a)(31)(A) (2000); 26 U.S.C. § 403(b)(10) (2000); 26 U.S.C. § 457 (d)(1)(C) (2000).

219. 26 U.S.C. § 457(e)(10) (2000).

220. 26 U.S.C. § 402(c)(1)(C) (2000).

221. 26 U.S.C. § 402(c)(6) (2000).

222. 26 U.S.C. § 402(c)(1)(C) (2000). *See also* Rev. Rul. 87-77, 1987-2 C.B. 115 (holding that there must be a "bona fide" sale of property in order for the cash to be a valid rollover contribution).

223. 26 U.S.C. § 408(d)(3)(A)(i) (2000).

In general, unless there is a direct rollover, the rollover must be effected within 60 days.²²⁴ However, EGTRRA has given the IRS discretionary authority to extend this time limit where it would be equitable to do so.²²⁵

The IRS recently ruled that a direct rollover from a qualified plan to an IRA could not be completed after the participant's death, even though he had done everything required of him to effect the rollover, and the funds were within two days of being transferred when he died. The ruling stated that:

[a]lthough not explicitly stated in either Code section 402(c), Code section 401(a)(31), or the regulations promulgated thereunder, a valid rollover, even if intended to be accomplished as a direct transfer as that term is defined in Code section 401(a)(31), necessitates the actual transfer of plan assets occur during the lifetime of the employee for whose benefit the plan account is maintained and for whose benefit the IRA is established.²²⁶

By contrast, where the distribution from the plan was received before the participant's death, the decedent's personal representative has been allowed to effect a rollover.²²⁷

The effect of the IRS ruling was to considerably shorten the period over which the plan benefits could be distributed, and thus to eliminate tax deferral opportunities that otherwise would have been

224. See generally 26 U.S.C. § 402(c)(3) (2000); 26 U.S.C. § 408(d)(3)(A), (D) (2000); 26 U.S.C. § 408(d)(3)(A) (2000) (requiring rollover be made within 60 days). The period runs from the date of actual receipt, not the date on which the check is issued or mailed. Priv. Ltr. Rul. 7950031 (Sept. 12, 1979). See also Priv. Ltr. Rul. 8833043 (May 26, 1988) (holding that time period for rollovers ends 60 days from date of receipt). If more than one distribution is received, the 60-day rule applies separately to each distribution. See Treas. Reg. § 1.402(c)-2 (2000) (stating in question and answer 11 that if an employee receives more than one distribution, "the 60-day rule applies separately to each distribution").

225. For distributions made on or after January 1, 2002, the Secretary may waive the 60-day requirement where the failure to do so "would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual." 26 U.S.C. § 402(c)(3)(B) (2000). See also 26 U.S.C. § 403(b)(8)(B) (2000) (announcing the same rule with respect to 403(b) arrangements); 26 U.S.C. § 408(d)(3)(I) (2000) (announcing the same rule with respect to IRAs). As before, there are special rules for "frozen deposits" which may not be withdrawn because of the bankruptcy or insolvency of a financial institution. See 26 U.S.C. § 402(c)(7) (2000) (announcing the rule with respect to qualified plans). See also 26 U.S.C. § 403(b)(8)(B) (2000) (announcing the rule with respect to 403(b) arrangements); 26 U.S.C. § 408(d)(3)(F) (2000) (announcing the rule with respect to IRAs). As under prior law, IRS also has authority to waive the 60-day limit for hardships that result from a presidentially-declared disaster or military service in a combat zone. See generally Treas. Reg. § 301.7508-1(a) (2000); Treas. Reg. § 301.7508-1A-1(a) (2000) (providing deadline extensions for service in combat zone and presidentially declared disasters).

226. Priv. Ltr. Rul. 200004038 (Oct. 30, 2001).

227. *Gunther v. United States*, 573 F. Supp. 126, 127 (W.D. Mich. 1982); see also Priv. Ltr. Rul. 8351119 (Sept. 23, 1983) (allowing rollover where distribution was received before decedent's death).

available to the beneficiaries.

The following additional simplifications should be made:

1. Allow rollovers of any actual distributions (including annuity payments, but excluding corrective distributions and required minimum distributions).
2. Eliminate the one rollover per year rule for IRAs²²⁸ and the rule that does not permit the cash equivalent of distributed property to be rolled over,²²⁹ 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.
3. Allow rollovers to be completed by the personal representative of a deceased plan participant or IRA owner, if the rollover requirements are otherwise met.

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. Recommendations 2 and 3 deal with rules that serve no useful purpose and may impede the portability of retirement plan assets.

*M. Plans That Hold Employer Securities*²³⁰

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. First, there are rules applicable only to ESOPs, as defined in Code section 4975(e)(7). These rules include: a special deduction limit for leveraged ESOPs;²³¹ non-recognition of capital gain on certain sales to an ESOP;²³² excise taxes on early disposition of, and for violating the non-allocation rules under Code section 409(n) relating to, stock acquired by the ESOP in a transaction subject to

228. 26 U.S.C. § 408(d)(3)(B) (2000).

229. 26 U.S.C. § 402(c)(1)(C), (c)(6) (2000).

230. Joint Committee on Taxation Background Information on Investment of Retirement Plan Assets in Employer Stock, BNA Pension & Benefits Reporter, Feb. 19, 2000, at 636. *See also* Joint Committee on Taxation, Description of Employer Sponsored Defined Contribution Plans and Other Retirement Arrangements for Senate Finance Committee Hearing, DAILY TAX REPORT (BNA), Feb. 27, 2000, at 39-DTR L-1 (discussing generally employer sponsored defined contribution plans); AMERICAN BENEFITS COUNCIL, Summary and Comparison of Select Retirement Legislative Proposals (May 6, 2002), available at <http://www.americanbenefitscouncil.com/documents/chartABC-050602.PDF> (last visited July 11, 2002) (summarizing several legislative proposals concerning limitations on acquiring or holding employer stock).

231. 26 U.S.C. § 404(a)(9) (2000).

232. 26 U.S.C. § 1042 (2000) (deferring recognition of gain on certain sales of stock to employee stock ownership plans).

section 1042;²³³ an exemption from the excise tax on reversions, for assets transferred to an ESOP between April 1, 1985 and December 31, 1988;²³⁴ and a 50% exclusion from gross income for interest received on an ESOP loan, and the related exemption from the below-market-interest loan rules.²³⁵

Second, there are rules that apply both to section 4975(e)(7) ESOPs and to tax credit ESOPs: an exemption from the joint and survivor annuity requirements;²³⁶ a diversification requirement;²³⁷ a rule requiring 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;²³⁸ a deduction for certain dividends paid on employer securities held by the ESOP;²³⁹ and an exemption from certain requirements of the anti-cutback rule.²⁴⁰ Certain rules apply only to tax credit ESOPs.²⁴¹

Finally, there are rules that must be satisfied by any section 4975(e)(7) ESOP or tax credit ESOP, and also by the other types of plan specified in the particular provision: voting rights with respect to employer securities;²⁴² the right to receive benefits in the form of employer securities;²⁴³ the requirement of a put option with respect to unmarketable securities;²⁴⁴ the accelerated distribution rules; and the requirements for payment of the price when the employer honors the put option.²⁴⁵

The need for the retention of each of these rules should be evaluated in the light of experience since the rule was enacted. The

233. 26 U.S.C. § 409(n) (2000); *see also* 26 U.S.C. § 4978 (2000) (imposing an excise tax on dispositions by employee stock ownership plans and cooperatives); 26 U.S.C. § 4979A (2000) (imposing an excise tax on prohibited allocations of qualified securities).

234. 26 U.S.C. § 4980(c)(3) (2000).

235. 26 U.S.C. § 133 (repealed 1996); 26 U.S.C. § 7872(f)(11) (2000) (these rules now apply only to loans made before August 21, 1996 and certain refinancings of such loans).

236. 26 U.S.C. § 401(a)(11)(C) (2000).

237. 26 U.S.C. § 401(a)(28)(B) (2000).

238. 26 U.S.C. § 401(a)(28)(C) (2000).

239. 26 U.S.C. § 404(k) (2000).

240. 26 U.S.C. § 411(d)(6)(C) (2000). *See also* 29 U.S.C. § 1054(g)(3) (2000) (providing an exception for certain employee stock ownership plans); Treas. Reg. § 1.411(d)(2000)-4, Q & A 2(b)(2)(iv), 2(d).

241. *See generally* 26 U.S.C. § 410(b)(6)(D) (2000); 26 U.S.C. § 409(b), (c), (d), (f), (i), (j), (m) (2000) (applying rules on tax credit ESOPs).

242. 26 U.S.C. § 409(e) (2000). *See also* 26 U.S.C. § 401(a)(22) (2000) (defining when § 409(e) applies).

243. 26 U.S.C. § 409(h) (2000). *See also* 26 U.S.C. § 401(a)(23) (2000) (providing that stock bonus plans are subject to the requirements of 26 U.S.C. § 409(h) (2000)).

244. 26 U.S.C. § 409(h) *See also* Treas. Reg. § 54.4975-7(b)(10), (12) (2000) (discussing "put options" for unmarketable securities).

245. 26 U.S.C. § 401(a)(23) (2000). *See also* 26 U.S.C. § 409(h)(5)-(6) (2000) (providing requirements for employer repurchase of securities); 26 U.S.C. § 409(o) (2000) (discussing further distribution requirements).

retained rules should apply to all qualified plans holding employer securities. 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 retained rules should apply to all plans holding employer securities, unless a good reason can be shown for departing from this principle of uniformity.

The Enron debacle has led to demands for new rules relating to investments by retirement plans in employer securities. Numerous bills have been introduced, and on April 11, 2002, the House of Representatives passed HR 3762, the Pension Security Act of 2002.²⁴⁶ Various professional groups have provided summaries of the various pending pension bills.²⁴⁷

N. Employer Aggregation

In determining whether retirement plans and other employee benefits qualify for tax-favored treatment under the Code, the employer aggregation rules generally require related employers to be treated as a single employer.²⁴⁸ 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.

The employer aggregation rules generally require a specified degree of common ownership in order for aggregation to apply. Accordingly, they appear not to apply to governmental employers, tax-exempt organizations, or other entities that do not have owners. However, on occasion, the IRS has taken the position that such entities are subject to aggregation.²⁴⁹ The IRS has requested comments on this issue and, pending the issuance of further guidance, a good faith compliance standard is in effect.²⁵⁰ 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.²⁵¹

246. See generally Profit Sharing/401(k) Council of America, *Summary of HR 3762, The Pension Security Act of 2002, As Passed by the House of Representatives on April 11, 2002* (Apr. 12, 2002), available at <http://www.psc.org/wash/hr3762.html> (last visited July 7, 2002) (summarizing HR 3762).

247. See American Benefits Council, *supra* note 230, at www.americanbenefitscouncil.com (last visited Sept. 6, 2002) (providing an example of a listing of legislative proposals).

248. See 26 U.S.C. § 414(b)-(c), (m)(1) (2000) (providing related employers must be treated as a single employer).

249. Priv. Ltr. Rul. 8706023 (Nov. 7, 1986). See also I.R.S. Notice 89-23, 1989-1 C.B. 654 (providing safe harbors for discrimination rules).

250. I.R.S. Notice 96-64, 1996-2 C.B. 229.

251. See 26 U.S.C. § 414(m)(4), (t) (2000) (failing to list Section 403(b)).

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 rules²⁵² 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.

In 1986, Congress enacted the separate line of business (SLOB) rules²⁵³ 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.²⁵⁴ Congress should instruct the IRS to issue new, more workable regulations.

O. The Pre-Termination Benefit Restrictions

As under pre-ERISA rulings, which limited the benefits that could be paid to any of the 25 highest paid employees prior to plan termination, there are special limits on the amount that can be distributed by a defined benefit plan to certain highly compensated employees.²⁵⁵ In certain cases, a larger amount can be distributed if the employee provides collateral to the plan. However, the employer may be forced to terminate the plan in order to be able to pay a lump sum to a highly compensated employee, as the collateralization exception may be impracticable²⁵⁶ if, for instance, the present value of the total benefit is less than 125% of the restricted amount.²⁵⁷

These benefit restrictions should be repealed, or their application limited to defined benefit plans that are subject to Code section 401(a)(4), but are not covered by the PBGC insurance program, such as plans of professional service employers with fewer than 26 participants.²⁵⁸ 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 severely restricted. In addition, the types of employers

252. 26 U.S.C. § 414(m)-(n) (2000).

253. 26 U.S.C. § 414(r) (2000).

254. See Treas. Reg. § 1.414(r)-(1)-(11) (2000) (providing special SLOB rules).

255. See Treas. Reg. § 1.401(a)(4)-5 (2000) (providing examples of how the regulation limits distribution of benefits to highly compensated employees); see also Rev. Rul. 92-76, 1992-2 C.B. 76 (analyzing Treas. Reg. 1.401(a)(4)-5).

256. See Treas. Reg. § 1.401(a)(4)-5 (2000). See also Rev. Rul. 92-76, 1992-2 C.B. 76 (analyzing Treas. Reg. § 1.401(a)(4)-5).

257. Pamela D. Perdue, *Going, Going, Gone: The Continuing Decline of the Traditional Defined Benefit Plan*, 26 J. PENSION PLANNING AND COMPLIANCE 1, 11-12 (2001).

258. 29 U.S.C. § 1321(b)(13) (2000).

to which the rule was directed have largely abandoned defined benefit plans.

The IRS should also issue guidance clarifying that, in situations where the benefit restrictions do apply, it is permissible for: (1) the lump sum present value of the employee's accrued benefit to be transferred to a separate account for that employee, within the defined benefit plan;²⁵⁹ and (2) that account to be credited, at least annually, with its proportionate share of the plan's actual investment earnings.

P. Cash Balance Plans

Under ERISA and the Code, a defined benefit plan is any plan under which the benefit is not determined solely by reference to the value of the participant's account.²⁶⁰ This covers a very wide range of possible plan designs, including hybrid plan designs such as cash balance plans. Much of the litigation and other troubles resulting from the increased use of cash balance plans have a very simple cause — basic ERISA concepts, like the “accrued benefit”²⁶¹ and anti-backloading rules,²⁶² work adequately for traditional defined benefit plans, but fail miserably when confronted with cash balance plans. As the ERISA Advisory Council noticed:

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.²⁶³

Congress should direct the Treasury Department and the IRS to review existing statutory and regulatory provisions governing the design and operation of defined benefit plans, and determine whether and how they should be modified to accommodate non-traditional defined benefit plan designs.²⁶⁴

259. 26 U.S.C. § 414(k) (2000).

260. 26 U.S.C. § 414(j) (2000); *see also* 29 U.S.C. § 1002(35) (2000) (defining “defined benefit plan”).

261. 26 U.S.C. § 411(a)(7) (2000); *see also* 29 U.S.C. § 1002(23) (2000) (defining “accrued benefit”).

262. 26 U.S.C. § 411(b)(1) (2000); *see also* 29 U.S.C. § 1054(b) (2000) (providing for benefit accrual requirements).

263. ERISA Advisory Council, Report/Recommendations of the Working Group Studying the Trend in the Defined Benefit Market to Hybrid Plans (Nov. 10, 1999) available at www.dol.gov/pwba/regs/fedreg/meetings/99012380.htm (last visited Sept. 6, 2002).

264. *See Hybrid Pension Plan Coverage: Retirement Into the 21st Century: Hearing of the Senate Health, Education, Labor and Pension Committee*, 107th Cong. (1999) (statement of Ron Gebhardtshauer, Senior Pension Fellow, American Academy of Actuaries). Gebhardtshauer stated:

[O]ne remedy for [whipsaw] would be for Congress to clarify that if the promise is an account balance with a yield that can be achieved in the

Cash balance plan sponsors have lost three recent cases concerning permissible interest rates to be used in calculating pre-retirement lump sum distributions.²⁶⁵ Also, a recent report issued by the Department of Labor's Inspector General asserted widespread benefit underpayments:

Our analysis of the 60 converted cash balance plans found that the conversions adequately protected benefits from earlier plans. However, in 13 of those 60 plans, we found that workers who left employment before normal retirement age did not receive all the accrued benefits to which they were legally entitled; being underpaid an estimated \$17 million each year. Applying the same estimation model used in our judgmental sample to the estimated 300 to 700 defined benefit plans that have converted to cash balance plans, we estimate that workers may be underpaid between \$85 million and \$199 million annually.²⁶⁶

The report recommended that the DOL should strengthen oversight of cash balance plans by:

1. Directing more enforcement resources to protecting cash balance plans' participant benefits.
2. Initiating specific enforcement action on the 13 plans with forfeitures identified in this audit.
3. Working with the IRS to develop improved guidance for plan administrators in calculating participant accrued benefits.²⁶⁷

The report acknowledged that PWBA disagreed with the report's methodology and questioned its conclusions, and "stated that without a broader survey of the problem and more detailed information it

markets, then the lump sum could be the amount of the account balance. In addition, some employers subsidize (or would like to subsidize) the annuity purchase rate to encourage participants to select annuities. One important question for Congress is whether this subsidy should be reflected in the lump sum. If it is, then it would discourage employers from subsidizing annuities - something Congress should want.

Id.

265. *Berger v. Xerox Corp.*, 157 F. Supp. 2d 998 (S.D. Ill. 2001); *Esden v. Bank of Boston*, 229 F.3d 154 (2nd Cir. 2000); *Lyons v. Georgia Pacific Corp.*, 221 F.3d 1235 (11th Cir. 2000); see also Alvin D. Lurie, *Whipsawed and Up the Creek Without a Respected Determination Letter*, 59 N.Y.U. INST. ON FED. TAX'N, EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION 7.03 (2001); *Cash Balance Cavalcade: Part I*, ERISA LIT. REP., Dec. 2000, at 28; *Benefit Accrual Rules 411(a)(11) ADEA*, ERISA LIT. REP., Feb. 2001, at 15; Douglas E. Motzenbecker, *Recent Case Law Developments Affecting Cash Balance Pension Plans*, 17 THE LABOR LAW 285, 285-92 (Fall 2001) (discussing generally the holdings in the three cases).

266. The U.S. DEPT. OF LABOR, OFFICE OF THE INSPECTOR GENERAL, *PWBA Needs to Improve Oversight of Cash Balance Lump Sum Distributions* (March 29, 2002), available at www.oig.dol.gov/public/reports/oa/2000/09-02-001-12-121.pdf (last visited Sept. 6 2002).

267. *Id.*

could not commit to redirecting enforcement resources to cash balance plan benefit calculations.²⁶⁸

In testimony given in September, 1999,²⁶⁹ Stuart Brown, then Chief Counsel of the IRS, made it clear that the IRS does not think that cash balance plans are inherently bad, but identified three areas of particular concern in connection with cash balance conversions: rate of accrual issues;²⁷⁰ protection of accrued benefits;²⁷¹ and age discrimination.²⁷²

Since 1999, the IRS, the DOL, and the EEOC have been reviewing the age discrimination issues relating to cash balance conversions: surely it is now time for them to publish their conclusions. In general, under federal employment discrimination laws, there are two types of discrimination claims: disparate treatment and disparate impact.²⁷³ The claim that cash balance plans discriminate is a disparate impact claim because it relies solely on the effect of the plan design. Before the Supreme Court's 1993 *Hazen Paper* decision, most people assumed that the ADEA permitted disparate impact claims. However, the Court questioned whether the disparate impact theory is available under the ADEA, and recent cases support the view that such a claim is not available.²⁷⁴

Q. *Interest Rates for Defined Benefit Plans*

For purposes of determining the plan's current liability and for determining the deficit reduction contribution under Code section 412(l) (additional funding requirements for under-funded single employer plans), the interest rate must be within the permissible

268. *Id.*

269. See *supra* note 265 (quoting Stuart Brown).

270. See generally 26 U.S.C. § 411(b) (2000) (establishing accrued benefit requirements).

271. 26 U.S.C. § 411(d)(6) (2000).

272. 26 U.S.C. § 411(b)(1)(H), (d)(2)(A) (2000). See also 29 U.S.C. § 1054(b)(1)(H) (2000) (prohibiting the cessation or reduction of benefit accruals on account of age); 29 U.S.C. § 623(i) (2000) (prohibiting age discrimination with respect to employee pension benefit plans).

273. As explained by the Supreme Court:

'Disparate treatment' . . . is the most easily understood type of discrimination. The employer simply treats some people less favorably than others because of their race, color, religion or other protected characteristics. Proof of discriminatory motive is critical, although it can in some situations be inferred from the mere fact of differences in treatment . . . Claims that stress "disparate impact" by contrast involve employment practices that are facially neutral in their treatment of different groups but that fall more harshly on one group than another and cannot be justified by business necessity. Proof of discriminatory motive . . . is not required under a disparate-impact theory.

Hazen Paper Co. v. Biggins, 507 U.S. 604, 609 (1993) (quoting *Int'l Brotherhood of Teamsters v. United States*, 431 U.S. 324, 335-36 (1977)).

274. See also *Eaton v Onan Corporation*, 117 F. Supp. 2d 812 (S.D. Ind. 2000) (holding that a cash balance plan did not violate federal age discrimination laws).

range. The permissible range is 90% to 110% (105% for the deficit reduction contribution) 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.²⁷⁵ 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% to 120% of the 4-year weighted average interest rate.²⁷⁶

The 30-year Treasury interest rate must also be used to determine the amount (if any) of the PBGC variable premium. The interest rate to be used in determining a single employer plan's variable rate premium is 85% of the annual yield on 30-year Treasury securities for the month preceding the beginning of the plan year for which premiums are paid.²⁷⁷ Again, Congress has granted relief for plan years beginning in 2002 and 2003: the plan can use 100% of the rate rather than 85%.²⁷⁸

In recent years, the mandated 30-year Treasury rate has been both volatile and unduly low. Rates are likely to fall even lower following the recent announcement that the Treasury Department will no longer issue 30-year securities.²⁷⁹ This problem should be addressed promptly, by replacing the Treasury interest rate with a more accurate rate, as it directly affects the financial soundness of defined benefit plans. Also, by introducing uncertainty, because the 30-year Treasury rates are so volatile, it (1) makes it considerably more difficult to fund defined benefit plans correctly and (2) makes defined benefit plans even less attractive to small businesses.

The sponsor of a defined benefit plan may need three different funding calculations: one for determining the minimum funding obligation under section 412; a second 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.

R. The PBGC Insurance Program

Under Title IV of ERISA, most defined benefit plans that are

275. See 26 U.S.C. § 412(b)(5)(B) (2000) (providing that the Secretary may reduce the lower end of the range from 90% to 80% if he finds that the lowest permissible rate is unreasonably high.)

276. 26 U.S.C. § 412(l)(7)(C)(i)(III) (2000), added by § 405(a)(1) of the Job Creation and Worker Assistance Act of 2000 ("JCWAA").

277. 29 U.S.C. § 1306(a)(3)(E)(iii)(II) (2000); PBGC Reg. 29 C.F.R. § 1306.4(b)(1) (2000).

278. 29 U.S.C. § 1306(a)(3)(E)(iii)(IV) (2000), added by § 405(c) of JCWAA (2000).

279. In March, 2002, IRS issued Notice 2002-26, which describes the methodology for calculating the rate of interest on 30-year Treasury securities, for purposes of 26 U.S.C. §§ 412 and 417 (2002). The rate was 5.71% for January, 2000, 5.70% for February, 2002 and 5.69% for March, 2002. In April, 2002, the IRS announced that the rate for April, 2002, was 5.69%. Notice 2002-28.

subject to ERISA are also subject to the PBGC termination insurance program.²⁸⁰ Accordingly, such a plan must pay annual premiums to PBGC, the plan may only be terminated in accordance with Title IV, and if the plan terminates with insufficient assets to pay all benefits, the benefits are guaranteed (up to certain limits) by PBGC.²⁸¹

In 1974, when ERISA was enacted, the annual PBGC premium was \$1 per participant. In 2002, the minimum annual premium is \$19 per participant, and plans which are determined to be less well-funded are required to pay an additional variable rate premium²⁸². “While a premium of \$19 is frequently argued to be trivial, compounded with interest over a working lifetime, it may reduce the average worker’s pension by \$600 to \$700 per year.”²⁸³

In 2000, PBGC premium income was about \$831 million.²⁸⁴ This money, paid either by the employer or by the plan, could otherwise have been used to provide benefits to plan participants. In the case of the vast majority of covered plans, that are more than adequately funded, this would have been far more beneficial for the participants in those plans. The expense of calculating and paying PBGC premiums is another factor that places defined benefit plans at a competitive disadvantage when compared to defined contribution plans.

Compliance with the requirements of Title IV imposes a significant financial and administrative burden on covered plans. In addition, since the single employer termination program was last revised significantly in 1980, economic conditions have changed considerably and the number of defined benefit plans has dropped precipitously. The PBGC insurance program almost certainly represents a barrier to adoption of new defined benefit plans, particularly by small employers.

Congress should mandate a comprehensive, independent study of the design and operation of the single employer termination program. At a minimum, consideration should be given to exempting small employers from PBGC coverage. This would make defined benefit plans significantly more attractive to small employers.

280. 29 U.S.C. §§ 1321(a) (plans covered) and (b) (2000) (plans not covered).

281. 29 U.S.C. §§ 1322 (single employer plans), 1322A (2000) (multi-employer plans).

282. The PBGC single employer program had a deficit through 1994: at the end of 1993, the deficit was \$2,897 million, and it was \$1,240 million at the end of 1994. At the end of 1999, it had a \$7,038 million surplus. *PBGC Pension Insurance Data Book*, 1999, Table S-1.

283. Theodore R. Groom and John B. Shoven, *How the Pension System Should Be Reformed*, September 8, 1999, prepared for the conference ERISA AFTER 25 YEARS: A FRAMEWORK FOR EVALUATING PENSION REFORM.

284. *Pension Insurance Fact Sheet*, available at www.pbgc.gov (last visited Sept. 6, 2002).

S. Coordination of Agency Jurisdiction and Statutory Provisions

An employer that sponsors a retirement plan must deal with the IRS, the DOL and the PBGC (for those who sponsor a qualified defined benefit plan). The roles of the three federal agencies in administering and enforcing the pension laws should be subject to a comprehensive review. The purpose would be to coordinate the activities of the three agencies in order to: (1) reduce the burden on employers of dealing with the separate agencies and (2) harmonize the objectives and enforcement priorities of the three agencies.

Federal pension law includes two main sets of rules: the rules specifying when retirement arrangements qualify for tax-favored treatment (the rules in the Code) and the rules conferring rights and protections on plan participants (the rules in ERISA). Conceptually, these rules are separate, and thus it is probably inevitable that they will be contained in separate statutes.

Most of the substantive pension rules appear both in the Code and ERISA. Generally, this is not a problem, although greater consistency in section numbering would make life easier for the non-specialist. However, there are discrepancies between the Code and ERISA. Some of these were in the original statute (for instance, different definitions of “employer securities” and “employee stock ownership plan” and, in the prohibited transaction rules, differences between “parties in interest” and “disqualified persons”). Some discrepancies have resulted from subsequent statutes that amended the Code but not ERISA. These discrepancies cause confusion, serve no useful purpose, and should be eliminated. The pension provisions of ERISA and the Code should be reviewed thoroughly, with a view to ensuring that the provisions of the two statutes are consistent, eliminating discrepancies and removing provisions that no longer serve any useful purpose.

Several of the leading proponents of ERISA wanted to establish a single federal agency, similar to the SEC, with jurisdiction over pension plans. I suspect that, despite the advantages of a single agency, political considerations will prevent its creation, as they did in 1974. If jurisdictional authority continues to be divided between several agencies, then it is important that their activities be consistent and coordinated, to reduce the regulatory burden on pension sponsors to a minimum.

T. Present Value Calculations

The 30-year Treasury interest rate must also be used in calculating minimum lump-sum benefits,²⁸⁵ and in calculating maximum benefits under Code section 415.²⁸⁶

Th[e] artificially low rate of interest on 30-year Treasuries relative to

285. 26 U.S.C. § 417(e)(3) (2000).

286. 26 U.S.C. § 415(b)(2)(E)(ii) (2000).

both the rate of interest on long-term corporate bonds and the rate of interest inherent in the pricing of insurance company annuity contracts. . . 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.²⁸⁷

According to the American Academy of Actuaries, the lump sum for a 45-year-old can be 30% more than the amount needed to buy an annuity (10% more for a 62-year-old).²⁸⁸

These unrealistically low interest assumptions are undesirable for two reasons. First, they offer a financial incentive to participants (to choose a lump sum rather than an annuity), which is not consistent with good pension policy. Second, they drain plan assets by requiring plans to pay more than the economic equivalent of the accrued annuity benefit.

U. Accrued Benefit Issues Under the Anti-Cutback Rule

In the case of a defined benefit plan, the term "accrued benefit" means:

1. If the plan provides an accrued benefit in the form of an annual benefit commencing at normal retirement age, that accrued benefit; or
2. Otherwise, an annual benefit commencing at normal retirement age which is the actuarial equivalent²⁸⁹ of the accrued benefit determined under the plan.

In general, the term "accrued benefit" refers only to pension or retirement benefits. Consequently, the accrued benefit does not include ancillary benefits not directly related to retirement benefits.²⁹⁰ The subsidized portion of an early retirement benefit may also be disregarded in determining benefit accruals.²⁹¹ Benefits under a defined benefit plan must accrue in accordance with one of the three methods described in the statute: the 3% method; the 133 1/3 rule; or the fractional rule.²⁹² In general, these definitions are adequate, for

287. Groom Law Group, *The Case for Dropping 30-Year Treasury Rates as the Benchmark for Valuing Liabilities in Defined Benefit Pension Plans*, at www.groom.com (last visited Sept. 6, 2002).

288. American Academy of Actuaries, *Pension Practice Council, Public Statement, The Impact of Inordinately Low 30-Year Treasury Rates on Defined Benefit Plans*, July 11, 2001.

289. Determined under 26 U.S.C. § 411(c)(3) (2000), 26 U.S.C. § 204(c)(3) (2000) and Treas. Reg. § 1.411(c)-1 (2000).

290. 26 U.S.C. § 411(a)(7)(A)(i) (2000); 26 U.S.C. § 3(23)(A) (2000); 29 U.S.C. § 1002(23)(A) (2000); Treas. Reg. § 1.411(a)-7(a)(1) (2000).

291. 26 U.S.C. § 204(b)(1)(H) (2000).

292. 26 U.S.C. § 411(b)(1)(A)-(C) (2000), and 26 U.S.C. § 204(b)(1)(A)-(C)

most purposes, in the case of a traditional defined benefit plan. However, in cases asserting violations of the anti-cutback rule, courts have struggled with what is included in the accrued benefit. In addition, the concepts are woefully inadequate in the case of hybrid plans, multi-formula plans and other nontraditional types of defined benefit plan. The cases have been inconsistent in their holdings as to what constitutes an accrued benefit for purposes of the anti-cutback rule.²⁹³ The IRS and the Treasury Department should consider issuing additional regulations to address these issues.

Second, the statute provides for the term "retirement-type subsidy" to be defined in regulations, but the regulations do not do so. The Committee report on REA states that

[t]he bill provides that the term "retirement-type subsidy" is to be defined by Treasury regulations. The committee intends that under these regulations, a subsidy that continues after retirement is generally to be considered a retirement-type subsidy. The committee expects, however, that a qualified disability benefit, a medical benefit, a social security supplement, a death benefit (including life insurance), or a plant shutdown benefit (*that does not continue after retirement age*) will not be considered a retirement-type subsidy. The committee expects that Treasury regulations will prevent the recharacterization of retirement-type benefits as benefits that are not protected by the provision.²⁹⁴

Unfortunately, it is not always clear whether a subsidy does continue after retirement. In *Bellas v. CBS, Inc. and Westinghouse Pension Plan*,²⁹⁵ the Westinghouse plan provided an actuarial subsidy that eliminated the normal actuarial reduction for benefit commencement before normal retirement age, in the case of participants whose employment was involuntarily terminated. The plan was amended to eliminate the subsidy, and the IRS issued a favorable determination letter on the amendment. The plaintiff was subsequently terminated and, 5 years after the amendment was adopted, the District Court held that the amendment violated section 204(g) of ERISA.

The court rejected the employer's argument that the subsidy terminated at normal retirement age, so was not a retirement-type subsidy and thus was not a protected benefit. The employer argued that the issue was whether the subsidy — not the stream of benefit

(2000). Special rules apply for service before the effective date of ERISA. 26 U.S.C. § 411(b)(1)(D) (2000), 26 U.S.C. § 204(b)(1)(D) (2000), and to fully insured plans. 26 U.S.C. § 411(b)(1)(F) (2000), 26 U.S.C. § 204(b)(1)(F) (2000). The plan may provide that no accruals become effective until the participant has two continuous years of service. 26 U.S.C. § 411(b)(1)(E) (2000), 26 U.S.C. § 204(b)(1)(E) (2000).

293. 26 U.S.C. § 411(d)(6) (2000); 26 U.S.C. § 204(g) (2000).

294. S. Rep. No. 98-575, at 30. (Emphasis added).

295. 73 F. Supp. 2d 500 (W.D. Pa., 1999), *aff'd*, 221 F.3d 517 (3d Cir. 2000), *cert. denied*, 121 S. Ct. 843 (2001).

payments – continued after normal retirement age.²⁹⁶ The court held that the benefit was a retirement-type subsidy because the plan expressly provided that “the amount calculated in accordance with Subsection 20.B.2(a) shall be payable for the lifetime of the Employee,” not only until age 65. The Third Circuit Court of Appeals affirmed the decision.²⁹⁷

By contrast, the Sixth Circuit has held that an actuarial subsidy incorporated in a shutdown benefit is not a retirement-type subsidy.²⁹⁸ The court also held that the subsidy was not an accrued benefit, an optional form of benefit or an early retirement benefit.²⁹⁹ The Service should clarify, preferably by regulation, when a subsidy continues after retirement age.

Third, with respect to plant shutdown benefits and other contingent benefits, the IRS has ruled³⁰⁰ that shutdown benefits that are “retirement-type benefits” are protected benefits, once the triggering event has occurred, and may not be reduced or eliminated: “Shutdown benefits that are retirement-type benefits, and not ancillary benefits, become accrued benefits and therefore are protected benefits under 411(d)(6) upon the occurrence of the event that triggers the right to payment of benefits. Shutdown benefits which are treated as supplemental or layoff benefits do not have such protection.”³⁰¹

296. Other types of subsidies clearly do continue after normal retirement age, such as (1) an increase in the pension formula (e.g., from 1% of final average salary (FAS) to 1.5% of FAS for each year of credited service), or (2) the grant of additional years of credited service in calculating the amount of the pension.

297. 221 F.3d 517 (3rd Cir. 2000), *cert. denied*, 121 S. Ct. 843 (2001). The Ninth Circuit reached a similar conclusion in *Richardson v. Pension Plan of Bethlehem Steel Corporation*, 67 F.3d 1462 (9th Cir. 1995). This opinion was, however, subsequently withdrawn [1996 US App. LEXIS 19036]. On rehearing, the court avoided the issue of whether there was a retirement-type subsidy, by holding that there was no amendment, only an interpretation of the plan (112 F.3d 982 (9th Cir. 1997)). See *Richardson Redux: The 9th Circuit Avoids Determining When a Plant Shutdown Benefit is a Protected Benefit Under Section 411(d)(6)*, 6 No. 3 ERISA Litig. Rep. 25 (1997). See generally *Arndt v. Security Bank SSB Employees' Pension Plan*, 182 F.3d 538 (7th Cir. 1999); *Ashenau v. Crucible, Inc. 1975 Salaried Retirement Plan*, 884 F.2d 1516 (3d Cir. 1988), *cert. denied*, 490 U.S. 1105 (1989); *Ross v. Pension Plan for Hourly Employees of SKF Industries, Inc.*, 847 F.2d 329 (6th Cir. 1988).

298. *Ross*, 846 F.2d at 329.

299. Ethan Lipsig, *The 9th Circuit Weighs In on the Immutability of Plant Shutdown Benefits and, For Good Measure, Seemingly Broadens Fiduciary Breach Remedies for Individual Plaintiffs*, 4 No. 5 ERISA Litig. Rep. 21 (1995).

300. G.C.M. 39869, April 6, 1992.

301. See generally *Ross v. Pension Plan for Hourly Employees of SKF Industries, Inc.*, 847 F.2d 329 (6th Cir. 1988) (holding shutdown benefits not protected); *Harms v. Cavenham Forest Indus., Inc.*, 984 F. 2d 686 (5th Cir. 1993) and *Wallace v. Cavenham Forest Indus., Inc.*, 707 F. Supp. 455 (D. Ore.

In *Bellas*,³⁰² a plan amendment eliminated a Permanent Job Separation (PJS) benefit. The plaintiff claimed that it was both an early retirement benefit and a retirement-type subsidy. The defendant argued that (1) given the wholly contingent nature of the benefit, it was not an early retirement benefit, and (2) because it was a contingent benefit and, because the subsidy ceased at normal retirement age, it was not a retirement-type subsidy. In deciding for the plaintiff, the court rejected the IRS position that a contingent benefit is not protected until the contingent event occurs.³⁰³

Regulations should be issued to clarify when contingent benefits become protected by section 411(d)(6). On June 26, 2002, the IRS and the Treasury Department requested comments containing suggestions for future proposed regulations concerning the elimination of optional forms of benefit from defined benefit plans, including

the types of situations in which the retention of particular optional forms of benefit under a defined benefit plan results in significant burdens and complexities for sponsors of retirement plans and for participants and the conditions under which these optional forms of benefit are of de minimis value to participants.³⁰⁴

V. DOMESTIC RELATIONS ORDERS

Benefits under qualified plans, and other retirement plans subject to ERISA, may be divided without current taxation, in connection with a divorce or other matrimonial proceeding, by obtaining, from the court or agency that has jurisdiction under state domestic relations law, a "qualified domestic relations order" or QDRO.³⁰⁵

Unfortunately, despite the importance of these rules, they are

1989) (both holding that shutdown benefits were protected); *Davis v. Burlington Indus., Inc.*, 966 F.2d 890 (4th Cir. 1992) (noting a violation of 411(d)(6) where amendment provided for benefits to be payable on termination of employment with purchaser rather than termination of employment with seller); *Blank v. Bethlehem Steel Corp.*, 926 F.2d 1090 (11th Cir. 1991) (holding that contingent rule of 65 benefits not protected); *Richardson v. Pension Plan of Bethlehem Steel Corp.*, 67 F.3d 1462 (9th Cir. 1995) (holding that plant shutdown benefit was a protected retirement-type subsidy); *withdrawn and reh'g granted* 112 F.3d 982 (9th Cir. 1997) (holding that the actions at issue were not a plan amendment); *Richardson Redux*, *The 9th Circuit Avoids Determining When a Plant Shutdown Benefit is a Protected Benefit Under Section 411(d)(6)*, 6 No. 3 ERISA Litig. Rep. 25 (August, 1997); *The 9th Circuit Weighs In On The Immutability of Plant Shutdown Benefits And, For Good Measure, Seemingly Broadens Fiduciary Breach Remedies for Individual Plaintiffs*, 4 No. 5 ERISA Litig. Rep., 21 (December, 1995).

302. 73 F. Supp.2d 500 (W.D. Pa., 1999), *aff'd*, 221 F.3d 517 (3d Cir. 2000), *cert. denied*, 121 S. Ct. 843 (2001).

303. *Id.* at 508-09. The court did not address whether the PJS was an early retirement benefit.

304. I.R.S. Notice 2000-46, 2000-28 I.R.B. 1.

305. 26 U.S.C. § 414(p) (2000); 26 U.S.C. § 206(d)(3) (2000).

not well understood, either by plan administrators or matrimonial attorneys, and the poor drafting of the QDRO rules, in particular, has given rise to a large volume of litigation. There should be a thorough review of these rules, with a view to making them simpler to apply in practice.³⁰⁶

IV. REFORM PROPOSALS

Each year, there are numerous proposals to simplify or reform the federal pension laws, emanating from legislators, interest groups, practitioners, economists and others. This section will briefly discuss some of the more interesting recent proposals.

Experience since the enactment of ERISA in 1974 suggests that it will be difficult to extend private pension plans to the remaining uncovered employees. Many work for small companies without a plan, and despite years of effort to ease the burdens on small companies, the gains have been small. This has led some commentators to conclude that future reforms should be based on individual savings rather than employer-sponsored plans. Thus, for instance, economist Robert Eisner proposed a voluntary, supplemental Social Security program offering three simple investment choices: 1) an equity index fund; 2) a bond index fund; and, 3) Treasury securities. Every worker covered by Social Security could make additional deductible contributions, which would be credited to his or her account. The annual limits would be the same as for 401(k) plans.³⁰⁷ Paul Weinstein has suggested a "universal pension" that would replace all of the current types of IRAs, including both employer-sponsored arrangements and individual arrangements.³⁰⁸ The key features of the universal pension would be universal access, greater choice (because it would be controlled by the individual, not the employer), simplification, and portability.³⁰⁹ According to Weinstein,

[a]lmost 40 percent of middle-income individuals aged 62 to 74 have pension income, while only 15 percent of lower-income retirees of the same age had pension income. Another study... finds that only 14 percent of families earning between \$10,000 to \$20,000 participated in a 401(k) plan, compared with 51 percent of those earning \$75,000 or

306. Despite the many areas of concern that have become evident since QDROs were introduced by REA in 1984, no regulations have even been proposed. The DOL issued an excellent booklet, "QDROs: The Division of Pensions Through Qualified Domestic Relations Orders," and sample QDRO language was provided in IRS Notice 97-11, 1997-1 CB 379. However, neither of these has the authority of a regulation.

307. See www.tcf.org; see generally ROBERT EISNER, SOCIAL SECURITY: MORE, NOT LESS (Twentieth Century Fund 1998).

308. Paul Weinstein Jr., *Universal Pensions: A Common-Sense Approach to Retirement Security in the New Economy*, Progressive Policy Institute Policy Report (Feb. 2002), available at <http://www.aarp.org/beyond50/2001/home.html#download> (last visited Sept. 6, 2001).

309. *Id.* at 1.

more. . . . The combination of Social Security, asset income, and pensions works well only among the top 20 percent of the aged. The bottom 20 percent rely on Social Security for over 80 percent of their income. . . . [t]he very complexity of the current system provides a disincentive to those who want to participate.³¹⁰

Features of the proposal include the following:

- The current 50% savers' credit, enacted by EGTRRA, would be made refundable, so that low-income families can benefit from it. At age 25, individuals would be encouraged to begin saving by an initial \$5000 deposit funded by the federal government.³¹¹
- The annual limit on deductible contributions would be the same as for IRAs (\$3,000 for 2002), and an individual who is not eligible for a 401(k) plan could contribute an additional \$10,000. Individuals with income above \$110,000, and couples with income above \$160,000, would be limited to a \$1,000 contribution.³¹² A small business could choose to match employee contributions rather than setting up its own plan.³¹³
- Unlike an employer-sponsored plan benefit, the universal pension goes with the worker from job to job, and all vested 401(k) accounts would automatically roll over into the universal pension when the worker changes jobs.³¹⁴

A 401(k) plan participant could choose to deposit a percentage of all existing and future contributions into the universal pension once vested.³¹⁵ House Minority Leader Richard Gephardt has introduced a bill to enact universal pensions.³¹⁶ Pamela Perun and Eugene Steuerle suggested a similar approach:

Under this proposal, IRAs achieve parity with employer plans through a coordinated individual savings limit. All workers, except perhaps the highest income workers, without an employer plan would be permitted the same level of deductible contributions as workers covered by a

310. *Id.* at 7 (citing AARP: Beyond 50: A Report to the Nation on Economic Security (2001)); Eric Engen and William Gale, *The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups*, Brookings Institution (2000), at www.brook.edu/dybdocroot/views/papers/gale/20000801.pdf (last visited Sept. 6, 2001).

311. *Id.* at 9. In his January 1999 State of the Union address, President Clinton proposed government subsidized retirement savings accounts, called USA accounts.

312. *Id.* at 8-9.

313. *Id.* at 10.

314. *Id.*

315. *Id.* at 10-11.

316. The bill is H.R. 4482, The Universal and Portable Pension Act of 2002. See Martin A. Sullivan, *With Little Fanfare, Gephardt Introduces Sweeping Pension Reform*, TAX NOTES, June 17, 2002, at 1709.

standard plan. Thus, we retain a simplified “discrimination” rule but one based on employee, not employer contributions. Contributions made to the standard plan would reduce the deductible limit under the IRA and vice versa. Canada, for example, has had a similar arrangement for many years with its IRA-equivalent “Registered Retirement Savings Program (RRSP).” Canadian tax law establishes an individual tax-deferred savings limit similar to the IRS section 415(c) limit. This limit is coordinated between contributions to an RRSP and any employer plan. Using this model in the U.S. would enable millions of Americans without an employer plan to increase their savings for retirement substantially.³¹⁷

Perun and Steuerle propose further that worthwhile incentives to moderate-income workers for additional retirement savings might be possible through the integration of some federal contribution into IRAs and employee savings plans.³¹⁸

Several other proposals focus on reforms to employer-sponsored plans rather than on individual savings. In its first (1989) report, the New York State Bar Association, Special Committee on Pension Simplification recommended “the immediate enactment of a statute offering strong inducements for the voluntary adoption of a very simplified type of plan.”³¹⁹ The proposed Baseline-Plus-Supplemental program would allow employers to adopt a baseline plan, either defined benefit or defined contribution, but not both. The plan would cover all employees who satisfy minimum age and length of service requirements, and who work more than part-time. The plan would provide for immediate (or very rapid) vesting; no integration with Social Security; contributions or benefits similar to the present top-heavy requirements; no participant loans; portability of benefits on termination of employment; and, generally, no distributions before the earlier of age 55 or normal retirement age, except for strictly defined hardships.³²⁰ An employer who adopted a baseline plan would also be able to adopt a more flexible supplemental plan that could have more restrictive eligibility criteria.³²¹

In December, 2001, the National Center for Policy Analysis issued a study that proposed a model 401(k) plan to correct flaws in current plans.³²² To address these flaws, the study proposed a new

317. PERUN & STEUERLE, *supra* note 5.

318. *Id.* For example, matching grants that enable savings within plans might be met using federal dollars, provided that such plans satisfy some minimum standard of portable benefits. *Id.*

319. New York State Bar Association, *A Process Awry: Federal Pension Laws*, 43 TAX NOTES 463, 473 (1989).

320. *Id.*

321. *Id.*

322. The National Center For Policy Analysis, *Reinventing Retirement Income In America* (Dec. 2001), available at www.ncpa.org/pub/st/st248 (last visited Sept. 6, 2002). The study cited the following major flaws: participants' lack of knowledge of investment principles; high and hidden administrative costs and management fees; participants cashing out their accounts when they

type of plan, the American Freedom 401(k) plan. An employer adopting the plan would have the benefit of safe harbors protecting it against lawsuits alleging a breach of fiduciary duty.³²³ The major features of the proposed plan include the following:

- Participants would have the opportunity to invest in efficient portfolios, such as index funds, or in portfolios managed by investment professionals;
- All employees would be automatically enrolled, and would contribute between 4% and 6% of pay, unless they affirmatively choose otherwise;
- The plan sponsor would be required to pay all plan fees and expenses, and to disclose them fully;
- Cashouts following termination of employment would be prohibited, whether initiated by the plan administrator or by the employee. All funds could be rolled over into another qualified plan, or remain in the plan if the new employer does not sponsor a plan;
- All benefits would be fully and immediately vested; and
- Loans and hardship distributions from the participant's account would be prohibited, but loans from the trust would be allowed.³²⁴

Daniel Halperin and Alicia Munnell proposed a two part approach that should generate a more satisfactory and efficient pattern of retirement income:

First, it provides for low-income workers directly through a program, like the Clinton Administration's Universal Savings Accounts proposal, which has a government-financed payment plus matching credits for individual contributions. Since employers are relieved of providing for their low-paid workers, some of the favorable tax treatment is removed through the imposition of a 5 percent tax on the investment earnings of pension funds. The second part is aimed at increasing coverage for the rank and file through enhanced incentives—namely, increasing contribution and benefit limits for employers who cover all workers in their organization.³²⁵

Finally Douglas Ell has proposed what he calls the "Perfect Plan," that would include all employees (including part-time) being eligible to participate (an employer could impose a two-year waiting

change jobs, rather than rolling them over; and hardship distributions and consumer loans.

323. *Id.*

324. *Id.*

325. See HALPERIN & MUNNELL, *supra* note 37. For a description of the authors' explanation of the underlying policy rationale, see Section II.B.3, *supra*.

period); full vesting at all times; mandatory employer contributions; employee salary reduction contributions; voluntary employer matching contributions; and portability. No distributions would be permitted before age 60, regardless of whether the employee is working, unless the employee is disabled.

Except as indicated above, a Perfect Plan would not be subject to coverage rules, nondiscrimination rules, minimum required distributions during the participant's lifetime, the top heavy rules, benefit accrual rules, joint and survivor annuity rules (Code Section 417), or anti-cutback rules (other than protection of the account balance).³²⁶

These proposals include many promising ideas. In addition, two provisions enacted by EGTRRA must be expanded if they are to fulfill their intended purposes. First, EGTRRA established an elective, non-refundable income tax credit for pension plan startup costs of small employers.³²⁷ The amount of the credit is equal to 50% of the "qualified startup costs." The credit is limited to \$500 for the first credit year and for each of the next two years, and is part of the general business credit. This is potentially an excellent incentive, but the amount of the credit is insufficient. The start-up costs that qualify would otherwise be deducted by the employer. There is a technical argument that these costs should be capitalized, but this type of technical argument tends to have little appeal for small employers and their tax advisors. Assuming a 35% corporate income tax rate, the maximum annual tax saving from electing the credit is only \$325.³²⁸ In addition to increasing the amount of the permissible credit, and perhaps extending it to at least part of the employer's contributions, it would be possible to allow a larger credit for adopting a defined benefit plan than a defined contribution plan.

Second, EGTRRA enacted a savers' credit, a new, non-refundable income tax credit for elective deferrals and/or IRA contributions.³²⁹ The amount of the credit is equal to the "applicable percentage" of the "qualified retirement savings contributions" up to \$2,000 per year. The applicable percentage is derived from the following table:

326. *Id.*

327. 26 U.S.C. § 45E (2000).

328. According to *The 2002 Small Employer Retirement Survey*:

2 in 10 non-sponsors indicate that the recent tax credit for the start-up costs of new retirement plans makes offering a retirement plan much more attractive for their business (19 percent). An additional 49 percent say that this tax credit makes offering retirement plans somewhat more attractive. However, 3 in 10 non-sponsors say that the EGTRRA tax credit does not make offering a retirement plan any more attractive for their business (31 percent).

Employee Benefit Research Institute, *The 2002 Small Employer Retirement Survey: 2002 SERS Summary of Findings* (May 7, 2002), available at www.ebri.org/sers/2002/02sersof.pdf (last visited Sept. 6, 2002).

329. 26 U.S.C. § 25B (2000).

Applicable	JOINT RETURN	HEAD OF HOUSEHOLD...	OTHER
Percentage	AGI	AGI	AGI
50%	\$30,000 or less	\$22,500 or less	\$15,000 or less
20%	\$30,001 to \$32,500	\$22,501 to \$24,375	\$15,001 to \$16,250
10%	\$32,501 to \$50,000	\$24,376 to \$37,500	\$16,251 to \$25,000
0%	Over \$50,000	Over \$37,500	Over \$25,000

In order to be effective, the AGI thresholds should be increased, and the credit should be made refundable.

V. CONCLUSION

The private pension system in the United States, as in all other industrial nations, will face unprecedented challenges during the next 30 years as a result of the aging population and the resulting financial pressures on Social Security and Medicare. In the shorter term, the system has been hurt by the weak economy and the stock market turmoil resulting from Enron, Worldcom and other recent corporate scandals. Pension simplification will not solve these societal problems, but their impact will be ameliorated if pension coverage can be extended, particularly to more low-income individuals and more employees of small businesses. Simplification is, in my view, an essential part of an ongoing campaign to encourage these individuals and businesses to join the system.